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STATE TAX CHANGES AT THE CLOSE OF THE FIFTIES

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THE decade about to close witnessed much tax activity in state legislatures. Concurrently, the states' tax take greatly increased. The larger part of that increase, however, was the product of economic growth rather than more taxes and higher tax rates. The dollar contribution of new legislation was nonetheless substantial; some of it, attributable to 1959 legislation, will not be fully reflected in collection statistics for another year. The voluminous legislation and larger tax-take notwithstanding, the general coloration of the state tax structures remains essentially as it was at the close of the nineteen forties.

Between 1950 and 1959 state tax collections exactly doubled, from $7.9 billion to $15.8 billion, and in the last year of the decade, in fiscal year 1960, will probably reach $17 billion. State governments' share of national resources increased at a conspicuously slower rate, by about one-sixth. Between 1950 and 1959 the ratio of state tax collections to gross national product moved from 3.1 per cent to 3.6 per cent; in terms of national income, from 3.6 per cent to 4.3 per cent. The principal contributor to the states' enlarged tax take was the increase in incomes, profits, consumption, and business activity. New tax enactments were only secondary contributors. Improved tax enforcement also played a part. The combined impact of these factors on the states' principal tax sources is reflected in Table I. These national totals submerge, of course, some far-reaching changes effected in the tax structures of a few of the states.

The revenue yield of the principal general tax categories has increased with remarkable uniformity: sales and gross receipts taxes, 99 per cent; licenses, 88 per cent; income taxes, 110 per cent; death and gift taxes, 108 per cent. Death and gift tax collections, which doubled without benefit of any significant legislation during the decade, illustrate the contribution of economic growth and price inflation to state revenues. In contrast, individual in-

* The author is an economist with the U. S. Treasury but this paper does not necessarily reflect the views of that agency. He is indebted to his colleague, Mildred D. Flinn, for access to her accumulation of state tax data, and to Harvey E. Brazer (Michigan), Charles F. Conlon (NATA), Walter W. Heller and Joe Robertson (Minnesota), Russell M. Mack (Ohio), Chester B. Pond (New York) and Ronald B. Welch (California) for illuminating bits of legislative color from their respective theatres of operation. The source of the legislative detail is Commerce Clearing House, *State Tax Reporter*.

come tax collections reflect increased tax rates and improved tax enforcement, (through withholding), as well as economic growth. Both reflect a high GNP elasticity.

The 1950's have left the composition of the state tax system virtually unchanged. As the last two columns of Table I indicate, the relative contribution of the principal tax categories has remained remarkably stable. Either by design or accident, the states have held tenaciously to the general coloration of their aggregate tax structure. This is all the more noteworthy because the decade was one of intensive legislative activity. Governors made voluminous tax recommendations and the tally of legislative enactments established new records.[1] In terms of revenue magnitudes, however, enactments fell markedly short of recommendations.

Table II presents a summary of some of the changes recorded in important components of the state tax structure during the present decade. Collectively the five taxes tabulated account for about two-thirds of state tax collections. Interesting developments oc-

TABLE I

State Tax Collections, 1950 and 1959

	Amount (in millions)		Per Cent Increase	Per Capita		Per Cent Increase or Decrease (–)	Per Cent Distribution	
	1950	1959[1]		1950[2]	1959[3]		1950	1959
Total collections	$7,930	$15,831	99.6%	$52.62	$91.70	74.3%	100.0%	100.0%
Sales and gross receipts	4,670	9,289	98.9	30.99	53.80	73.6	58.9	58.7
General sales or gross receipts	1,670	3,694	121.2	11.08	21.39	93.1	21.1	23.3
Motor fuels	1,544	3,048	97.4	10.25	17.65	72.2	19.5	19.3
Alcoholic beverages	420	599	42.6	2.79	3.47	24.4	5.3	3.8
Tobacco products	414	680	64.3	2.75	3.94	43.3	5.2	4.3
Insurance	241	548	127.4	1.60	3.17	98.1	3.0	3.5
Public utilities	185	364	96.8	1.23	2.11	71.5	2.3	2.3
Other	195	357	83.1	1.29	2.07	60.5	2.5	2.3
License	1,228	2,310	88.1	8.15	13.38	64.2	15.5	14.6
Motor vehicles	702	1,381	96.7	4.66	8.00	71.7	8.9	8.7
Corporations in general	176	360	104.5	1.17	2.08	77.8	2.2	2.3
Alcoholic beverages	77	85	10.4	.51	.49	–3.9	1.0	.5
Hunting and fishing	60	108	80.0	.40	.63	57.5	0.8	.7
Other	213	376	76.5	1.41	2.18	54.6	2.7	2.4
Income	1,310	2,757	110.5	8.69	15.97	83.8	16.5	17.4
Individual income[4]	724	1,778	145.6	4.80	10.30	114.6	9.1	11.2
Corporation net income[4]	586	979	67.1	3.89	5.67	45.8	7.4	6.2
Property	307	565	84.0	2.04	3.27	60.3	3.9	3.6
Death and gift	168	349	107.7	1.11	2.02	82.0	2.1	2.2
Severance	211	392	85.8	1.40	2.27	62.1	2.7	2.5
Other	36	170	372.2	.24	.99	312.5	.5	1.1

Source: Bureau of the Census, Governments Division.
Note: Detail will not necessarily add to totals due to rounding.
[1] Preliminary.
[2] Based on the April 1, 1950 population.
[3] Based on the estimated July 1, 1958 population.
[4] Individual income tax figures include corporation net income tax amounts for three states in 1950 and two states in 1959.

[1] See, for example, "State Tax Activities, 1955" in *National Tax Journal*, December 1955, p. 345, and "State Taxes After the 1956-57 Legislative Sessions" in *National Tax Journal*, December 1957, p. 289.

TABLE II

RATES OF SELECTED STATE TAXES, 1950 AND 1960
(On the basis of legislation enacted by November 1, 1959)

	Personal Income Tax[1]		Corporation Income[2]		Retail Sales		Motor Fuel		Cigarettes	
	1950	1960	1950	1960	1950	1960	1950	1960	1950	1960
Alabama	1.0%	1.0%	3% F	3% F	2%	3%	6¢	7¢	3¢	6¢
Alaska	1.0	1.7	3.8	9			2	5	3	5
Arizona	.6	.5	5 F	5 F	2	3	5	5	2	2
Arkansas	.3	.7	5	5	2	3	6.5	6.5	4	6
California	.3	.3	4	5.5	3	3	4.5	6		*3*
Colorado	.8	1.8	5 F	5	2	2	6	6		
Connecticut			3	3.75	2	3	4	6	3	3
Delaware	.7	1.5		*5*	-		5	5	2	3
Florida					3	3	7	7	5	5
Georgia	.7	.4	7 F	4		*3*	7	6.5	5	5
Hawaii	2.3	2.7	10	5.5	2.5	3.5	4	5	3	3.5
Idaho	1.5	2.9	8 F	9.5 F			6	6	3	5
Illinois					2	3	3	5	3	4
Indiana					5/8	3/8	4	6	3	3
Iowa	1.8	1.8	2 F	3 F	2	2	4	6	2	4
Kansas	.6	.9	2 F	3.5 F	2	2.5	5	5	3	4
Kentucky	2.0	2.6	4.5 F	7 F			7	7	2	3
Louisiana	1.1	.1	4 F	4 F	2	2	9	7	8	8
Maine						*3*	6	7	4	5
Maryland	.9	1.4	4	5	2	3	5	6		*3*
Massachusetts	.9	1.4	6.765	6.765			3	5.5	5	6
Michigan					3	3	3	6	3	5
Minnesota	1.8	3.3	6.3 F	9.3 F			5	5	4	5.5
Mississippi	.4	0	6	6	2	3	6	7	4	6
Missouri	.7	.7	2 F	2 F	2	2	2	3		*2*
Montana	.8	1.4	3 F	4.5			6	6	2	8
Nebraska							6	7	3	4
Nevada						*2*	4.5	6	3	3
New Hampshire	[3]	[3]					4	7	2.5	3
New Jersey				*1.75*			3	5	3	5
New Mexico	.5	.5	2F	2 F	2	2	7	6	4	5
New York	1.1	1.7	5.5	5.5			4	6	3	5
North Carolina	1.9	1.9	6	6	3	3	6	7		
North Dakota	.8	.6	6 F	6 F	2	2	4	6	5	6
Ohio					3	3	4	7	2	5
Oklahoma	.5	.5	4 F	4 F	2	2	6.5	6.58	5	5
Oregon	2.8	3.4	8	6			6	6		
Pennsylvania			4	6		*4*	5	5	4	6
Rhode Island			4	5.5	1	3	4	6	3	5
South Carolina	1.6	1.3	4.5	5		*3*	6	7	3	5
South Dakota					3	2	4	6	3	5
Tennessee	[3]	[3]	3.75 F	3.75	2	3	7	7.6	3	5
Texas							4	5	4	8
Utah	1.8	1.4	3 F	4 F	2	2	4	6	2	4
Vermont	2.0	2.7	4	5			5	6.5	4	7
Virginia	1.3	1.3	5	5			6	6		
Washington					3	4	6.5	6.5	4	6
Wisconsin	1.4	2.1	6 F	7 F			4	6	3	5
West Virginia					2	2	5	7	1	5
Wyoming					2	2	4	5		*4*
Total[4]	33	33	34	36	29	34	50	50	42	46

(See notes next page)

curred in other taxes as well, but they do not lend themselves to simple tabular summation. The story of the five important taxes can be quickly told and reveals the interstate variety embraced within national totals.

During the ten years, two states added corporation income taxes, five retail sales taxes, four cigarette taxes, but none personal income taxes. The median effective income tax rate on a family of four with a net income of $6,000 (corresponding to about $6,700 of gross income) increased from 0.9 per cent in 1950 to 1.4 per cent in 1960.[2] Nearly half of the states continued their corporation income tax rates unchanged throughout the decade. The median corporation income tax rate increased from 4.5 per cent to 5 per cent.[3] The increase in effective corporate rates was somewhat greater because four of the 18 states which allowed federal income taxes as a deduction in 1950 discontinued it before 1960. During the decade the median retail sales tax rate moved from 2 to 3 per cent, the median gasoline tax rate from 5 to 6 cents and the median cigarette tax rate on a standard package of 20 from 3 to 5 cents.

[2] While only about 25 per cent of the spending units fell above this income level in 1958, they accounted for about 50 per cent of total money income. (*Federal Reserve Bulletin*, July 1959, p. 713.)

[3] For the eight states with graduated rates, the median rate was computed on the basis of the tax rate applicable to the top tax bracket which in only four states begins as high as $25,000.

These comparisons relate only to state imposed taxes which represent about half of the state and local aggregates. Developments at the local level, however, were equally unspectacular for the nation as a whole. With the exception of local retail sales taxes which now blanket California and Illinois and local income taxes in Ohio and Pennsylvania, the tax apparatus of the 100,000 taxing jurisdictions has changed little since 1950. Local government continues to rely primarily on the property tax for locally raised tax revenue.

State tax legislative activity appeared to be gathering momentum as the decade's end approached, apparently because requirements continued to outpace revenues. Despite a three-fold increase in state indebtedness in ten years, pressures for larger state appropriations for education, health, urban development, water supply, the aged, etc., persisted, and the governors' recommendations for tax increases submitted to the 1959 legislatures reached a new high, aggregating approximately $1.4 billion.[4] Moreover, while several governors' tax programs were wholly or partially rejected, a number of the governors scored conspicuous legislative

[4] In addressing the 51st annual meeting of the Governors' Conference in August 1959, the Governor of Minnesota identified four kinds of pressures for revenue:

(1) "The pressure of affluence, which generates demands for government services faster than it generates revenue to pay for them;

Note: Italicized rate indicates that tax was not imposed in 1950. The calculations disregard post-1950 changes in the secondary provisions of income tax laws.

[1] Effective rate on $6,000 of net income (after deductions but before exemptions) for a married couple with two dependents.

[2] For the 8 states with graduated corporation rate structures, the rate applicable to the top bracket is shown.

[3] Taxes only income from intangibles.

[4] The count of states includes Alaska and Hawaii for both 1950 and 1960.

F. The state allows the federal income tax as a deduction. Wisconsin limits the deduction to 10 per cent of net income.

successes. The 1959 tax enactments were numerous and varied and in several instances strikingly large.[5]

The outstanding events of 1959 were the legislative success of the governors' large-scale programs in California ($223 million), New York ($273 million) and Ohio ($311 million for the biennium), the legislative failure of the governors' programs in Massachusetts and Michigan, further spread of withholding in the collection of personal income taxes, continued state adoption of Federal Revenue Code definitions, some progress in eliminating the deduction of federal income taxes for state tax purposes, the increasing vogue of tobacco taxes, and the beginnings, after many years, of a legislative interest in increasing death taxes. Equally striking was the effectiveness of taxpayer groups in vitiating tax legislation by forcing its submission for electoral scrutiny in Oregon and Oklahoma and in successfully challenging its constitutionality in Michigan.

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(2) "the pressure of population growth, which in the period of 1946-65 is expanding the 'expensive' age groups (school age and over 65) more than three times as fast as the productive middle groups (18 to 65 years);

(3) "the pressure of public construction needs, which is intensified not only by the lag in public construction during the war, but by the flight to the suburbs that demands new roads, new schools, sanitary facilities, parks, and other public works; and

(4) "the pressure of inflation which . . . has resulted in an especially high burden on goods that state and local governments have to buy, . . ." (Executive Office, St. Paul, Minnesota, Press Release, August 4, 1959.)

[5] The possibility of additional legislation before the end of the year is not foreclosed since some legislatures have not yet adjourned. Wisconsin is scheduled to reconvene to consider tax legislation and Michigan to consider replacement for the sales tax increase recently nullified by the State Supreme Court.

Personal Income Taxes

Income taxation received an unusual amount of legislative attention during the year. Thirty of the states whose legislatures convened in 1959 tax personal incomes and all but six changed their laws in one or more respects. However, the line held firmly against new income tax enactments, as it has every year since 1937. Michigan again considered and rejected this tax. The question may, however, be reopened very soon.

The 1959 legislation covered the entire gamut of income tax provisions from tax rates, exemptions, deductions and tax credits to payment provisions. Income tax rates were increased in California, Colorado, Idaho, Minnesota, Montana, New York and South Carolina. California halved the size of its tax rate brackets, raised the maximum rate from 6 to 7 per cent and stopped graduation at $15,000 instead of $25,000. Colorado increased its bracket rates below $8,000 and reduced those above $11,000. It also raised the exemption from the 2 per cent surtax on intangible income from $600 to $5,000. Idaho increased its rates, imposed a $10 flat filing fee on all persons required to file tax returns and adopted income splitting. Montana's rate increases range from ½ of 1 per cent to 2 per cent. South Carolina's rate increases were limited to the two top brackets. Minnesota split the first bracket and increased all bracket rates above $500 by ½ of 1 per cent. New York added new brackets to the top of its graduated rate schedule increasing the maximum rate from 7 per cent to 10 per cent. Three corresponding brackets with rate increases were added to its capital gains tax rate schedule. In Massachusetts a

temporary tax rate increase scheduled to expire was extended and in Wisconsin the temporary surtax was increased from 20 per cent to 25 per cent and extended. The Massachusetts legislature, moreover, took the initial step in the direction of a constitutional amendment to permit graduated tax rates.

California and New York reduced personal exemptions for single persons and married couples but increased credits for dependents. The new California exemptions are $1,500 and $3,000, $500 less than before, and the credit for dependents $600 instead of $400. New York adopted the federal $600 per capita personal exemption system across-the-board, which represents an increase in the credit for dependents and in the additional exemptions for those over 65 or blind. However, it provided tax relief to all taxpayers by allowing a tax credit of $10 for single persons and $25 for married couples. Minnesota raised its tax credit for dependents, (employed in lieu of personal exemptions), from $10 to $14. Utah and Kansas adopted the federal rule on dependents for children attending school by waiving the $600 income limitation.

During the year, South Carolina and Oregon discontinued the deductibility of federal individual income taxes for state income tax purposes. More than half of the states (18) continue to allow this deduction. The elimination of the tax deduction in Oregon was coupled with reductions in individual income tax rates so as to result in about a 9 per cent increase in tax liabilities. The legislation, however, has been suspended by referendum petition, pending electoral disposition in November 1960. Colorado removed the limitations on the deduction of medical expenses and now permits such expenses to be deducted in full.

The trend toward state adoption of provisions of the Federal Revenue Code continued. Idaho and North Dakota joined Iowa, Kentucky and Vermont in accepting (with some adjustments) net income as determined for federal income tax purposes. Iowa, which had formerly tied its statute to the Federal Revenue Code of 1954, has now substituted the Code as amended through December 31, 1958. Alaska has retained its territorial provision which imposed an income tax equal to 14 per cent of federal tax liability. A constitutional admendment to permit New York's legislature to adopt definitions of the Federal Revenue Code for state tax purposes was approved 2:1 in the November 1959 election. California adopted federal depreciation allowances and capital gains treatment. Colorado increased child care and sick pay allowances. The latter was adopted also by Kansas. Delaware and North Dakota adopted the institution of the standard deduction, and New York raised the maximum limitation on its standard deduction from $500 to $1,000. Massachusetts and New Mexico are now alone in not affording their taxpayers the standard deduction option. Mention should be made also of the extension in Colorado of the optional tax table to incomes not in excess of $10,000, and Kansas' adoption of a short tax form for individuals with not more than $5,000 of income primarily from wages and salaries.

Oregon, which treats capital gains as ordinary income regardless of the length of time the assets were held, has adopted a capital gains provision with a new

"incentive" feature to encourage the reinvestment of capital gains within the state. A new law gives the taxpayer an election to have his capital gains specially treated. In order to avail himself of this special treatment he must invest the capital gains "in good faith" (meaning for a period of at least three years) in certain specified investments within the tax year in which the capital gains are realized, or within a period designated by the Commission upon application. If the taxpayer complies with all the required conditions, then capital gains so invested are includable in gross income only to the extent of 80 per cent if derived from assets which had been held more than one but less than two years, 60 per cent if held from two to five years, and 50 per cent if the asset had been held over five years.

The only other change noted in the states' capital gains provisions is an increase in the six-month holding period in Colorado to 30 months for purposes of differentiating between short-term and long-term gains and losses.

Georgia has undertaken to encourage contributions to educational institutions by allowing a credit for such contributions against the tax otherwise payable without any apparent limitation. This unique provision is reproduced verbatim below.[6]

Minnesota, New York and North Dakota have liberalized the treatment of residents paying taxes to other states while North Carolina has discontinued the tax credit formerly allowed nonresidents for taxes paid to their home states.

The employment of withholding for collecting income taxes from wage and salary recipients made further strides. Massachusetts, New York, North Carolina, Oklahoma, South Carolina and Utah adopted general withholding provisions. This raises the total to nineteen states, including Alaska and Hawaii. Oklahoma's withholding, however, has been suspended, at least temporarily, by a petition bearing the 40,000 signatures required to hold up the application of the law. The Secretary of State, who had originally declined to accept the referendum petition, has been directed to do so by the State Supreme Court and reportedly has filed a petition for a rehearing.

The states which had in the past adopted withholding, used the occasion to telescope the collection of more than one year's tax liabilities into a single year. New York departed from this pattern by coupling the introduction of withholding with forgiveness of 1958 taxes, except those on capital gains. Estates, trusts and deceased persons are excluded from the forgiveness of 1958 taxes. Withholding was considered also but rejected in Minnesota and was em-

[6] The statutory provision reads: "There shall be allowed as credit against, and deducted from the tax otherwise payable under this chapter by any taxpayer an amount equal to any contribution which such taxpayer shall have paid during the taxable year on account of which such tax is payable to any corporation, foundation or trust, if, but only if, at the time of such payment such corporation, foundation or trust has in full force and effect a certificate from the State Revenue Commissioner certifying under this section that such corporation, foundation or trust is organized and operated exclusively for educational purposes and that no part of the net income of said corporation, foundation or trust inures to the benefit of any private shareholder or other individual. The issuance of such certificate shall be at the discretion of the State Revenue Commissioner. The existence of such certificate from the State Revenue Commission is a condition precedent to the credit allowed by this section 92-3111(a) and no such credit shall be allowed unless the corporation, foundation or trust to which such contribution is paid holds such certificate in full force and effect at the time such payment is made. If a credit is allowed under this section, no deduction shall be allowed under section 92-3109 as amended for the same payment."

braced in the governor's rejected income tax proposal in Michigan.

A novel feature of the Massachusetts withholding law is the reimbursement of employers for expenses incurred by them. A similar provision was subsequently included in Oklahoma's suspended withholding statute. In the meanwhile, however, the Congress enacted Public Law 371, approved September 23, 1959, to exclude from the benefit of state reimbursement provisions federal agencies which withhold state taxes from their employees.[7]

With respect to income taxation at the local level, the only legislative development noted this year was the authority granted St. Louis, Missouri, to increase its income tax from ½ per cent to 1 per cent. St. Louis did so on August 1, 1959, following electoral approval.

Corporate Income Taxes

Corporation net income is presently taxed by 36 states and a fourth of them amended their laws this year. Tax rates applicable to corporations generally were revised in four states. California increased its rate from 4 to 5½ per cent and its minimum tax from $25 to $100. Idaho raised its rate from 8.8 per cent to 9.5 per cent and imposed a $10 filing fee. Iowa moved its rate from 2 to 3 per cent; and Minnesota from 7.3 to 9.3 per cent. South Carolina boosted the rate applicable to the net income of building and loan associations and savings and loan associations and Utah the rate applicable to banks. Oregon reduced the rate payable by public utilities by subjecting them to the lower general corporation rates. Past rate increases scheduled to expire were extended by Connecticut, Massachusetts, Pennsylvania and Rhode Island. Montana reduced its corporate rate from 5 to 4½ per cent but at the same time disallowed deductions for federal income taxes, thereby increasing tax liabilities significantly. Colorado also disallowed the deduction of federal income taxes, but a similar recommendation in Minnesota was rejected.

Several states moved further in the direction of adopting Federal Revenue Code provisions for state tax purposes. Idaho incorporated federal definitions of net income with necessary adjustments for such items as income taxes paid and government bond interest received. Minnesota adopted federal provisions respecting trade and business expenses, losses, bad debts and depreciation, as well as the new federal provisions providing additional first-year depreciation. The last mentioned provision was adopted also by Kansas and North Dakota. Two states, Iowa and Montana, followed the federal lead in giving stockholders of small corporations the option to be taxed as partnerships. Oregon added a provision subjecting tax-exempt organizations to taxation on their unrelated business income.

California and Iowa provided for installment payment of corporation taxes and Montana enacted a novel provision which denies corporations (with income originating within the state) deductions for salaries paid, if recipients of those salaries fail to pay Montana income tax.

During the year the tax status of income derived from interstate commerce

[7] Federal departments and agencies comply with the states' withholding provisions on the basis of agreements negotiated with the individual states by the Secretary of the Treasury pursuant to Public Law 587, 82d Congress, approved July 17, 1952. Such agreements are now in force with all states having general withholding provisions.

received nation-wide attention. The immediate focus of this attention was the six to three decisions of the U. S. Supreme Court in the *Portland Cement* and *Stockham Valves* cases [8] holding that where a foreign corporation comes into a state solely to solicit sales, that state may tax its income " provided the levy is not discriminatory and is properly apportioned on local activities within the taxing state forming a sufficient nexus to support the same." In the wake of the Supreme Court decisions, Alaska, Idaho, Tennessee and Utah revised their statutes to permit full taxation of out-of-state corporations doing business within their borders. At least one state, Colorado, amended its regulations within the framework of the existing law to reflect the 1959 decisions of the Supreme Court.

The decisions and subsequent state legislation caused considerable consternation in the business community and resulted in federal legislation.[9] The new federal statute exempts from state taxation income derived from the sale of tangible personal property in interstate commerce where the only business activity within the state by the out-of-state company is solicitation of orders. It provides also that an out-of-state business shall not be considered to be conducting business activities within the state by reason of solicitation of orders or sales in that state in its behalf by an independent contractor, even if such an independent contractor maintains an office within the state. The federal legislation is believed to have a preventive purpose, to forestall the extension of state taxation of income derived from interstate commerce pending further clarification. With this in view, it directs the House Committee on the Judiciary and the Senate Committee on Finance to undertake a study of state taxation of income derived from interstate commerce and to file their report with legislative recommendations by July 1, 1962.

[8] *Northwestern States Portland Cement Company* v. *State of Minnesota; T. V. Williams, as State Tax Commissioner* v. *Stockham Valves and Fittings, Inc.*, 358 U. S. 450, 79 Sup. Ct. 357.

[9] Public Law 86-272, approved September 14, 1959.

Death and Gift Taxes

The death and gift tax area, which has been relatively dormant for some time, experienced some legislative activity during the year. The minor role of these levies (2.2 per cent in 1959) in the states' revenue system, however, has not been affected.

California eliminated the federal estate tax as a deduction for state tax purposes and raised the rates applicable to bequests and gifts to remote relatives and strangers. Maine also increased rates on remote relatives and raised exemptions as well. New York, Minnesota and Ohio initiated general rate increases but Ohio also increased exemptions. Oregon reduced the number of brackets in its rate structure and in the process lowered its top bracket rates. Minnesota and Oregon made gift tax rate adjustments, Colorado increased the annual gift tax exclusion, and Tennessee extended the exemptions of charitable gifts to out-of-state organizations on condition of reciprocity.

Sales and Use Taxes

Sales tax activity was again limited to the 34 states with established sales taxes. There were no new enactments. The Massachusetts legislature rejected Governor Furcolo's recommendation for a 3 per cent sales tax to produce $120

million. The tax, however, enjoyed considerable tolerance, if not popularity, in other state legislatures.

Five states, Arizona, Illinois, Michigan, Pennsylvania and Washington, increased their rates, the first two to 3 per cent; the others to 4 per cent. Michigan's tax increase was subsequently found to be unconstitutional by the state's Supreme Court. The 1 per cent addition to the 3 per cent rate had been enacted in the form of a use tax " on all purchases of taxable goods and services purchased in or out of the State " because Michigan's constitution limits the sales tax to 3 per cent.

During the year, Missouri enacted a use tax to safeguard its 2 per cent general sales tax. All other sales tax states already had use taxes. North Dakota and Rhode Island extended temporary rate increases scheduled to expire.

Nine states broadened the base of their sales taxes by removing exemptions. Transient lodgings was a popular addition. Vermont, which has no general sales tax, imposed a 3 per cent excise on transient lodgings.

As a result of the 1959 enactments, (and excluding the Michigan " use " tax) the distribution of the state sales tax rates is now: 2 per cent, 12 states; 2½ per cent, 1; 3 per cent, 17; 3½ per cent, 1 (Hawaii); and 4 per cent, 2 states. Indiana, which has a multi-stage sales tax, taxes retail sales at ⅜ths of 1 per cent. In some of these states, retail sales are subject also to local taxes; in two with 3 per cent state taxes, local sales taxes are almost state-wide (½ per cent in Illinois and 1 per cent in California). Utah, which has a 2 per cent state tax, authorized its cities and counties to add ½ of 1 per cent local taxes. The authority has already been utilized by some Utah jurisdictions, including Salt Lake.

Gasoline Taxes

Although gasoline tax rate increases figured frequently in the governor's recommendations at the start of the year, only four enactments materialized. Uncertainty regarding the outcome of the President's recommendation on the subject with its direct effect on allocations from the Highway Trust Fund was doubtless a contributing factor. In his January Budget Message the President had proposed an increase in the federal tax rate from 3 cents to 4½ cents per gallon for a 5-year period beginning July 1, 1959. The legislation, Public Law 86-342, as finally approved on September 21, provided for an increase to 4 cents for the 21 months ending June 30, 1961.

During the year New York and Ohio added 2 cents and New Hampshire and West Virginia 1 cent to their gasoline tax rates. California, Connecticut and Pennsylvania extended temporary increases scheduled to expire.

At the close of the year the gasoline tax rate was 5 cents in 11 states,[10] 6 cents in 19 states and 7 cents in 13 states. One state has a 5½ cent rate and five have 6½ cent rates. Missouri's 3 cent rate is the lowest in the country, but in that state, as in eight others, motor fuel is taxed also by local jurisdictions. Some of these states impose differential rates on diesel fuel.

Beverage Taxes

The following states increased their taxes on beer, wine and alcoholic spirits:

[10] Including Hawaii, where an 8 cent state rate is in effect in Hawaii County.

Beer	*Wine*	*Spirits*
California	Colorado	Colorado
Colorado	Illinois	Illinois
Illinois	New Mexico	Minnesota
Minnesota	Oklahoma	New Mexico
Montana	So. Carolina	Oklahoma
Ohio	Texas	Texas
Oklahoma		
So. Carolina		

In addition to these, mention should be made of Pennsylvania's and Ohio's sales tax revisions subjecting alcoholic beverages to the retail sales tax, to the extension of temporary taxes on alcoholic beverages in Massachusetts, Michigan and Vermont, and to the repeal of prohibition in Oklahoma, followed by adoption of a comprehensive liquor control act imposing taxes on all forms of alcoholic beverages. Approval of the repeal amendment to the Oklahoma constitution leaves Mississippi as the only dry state.

Tobacco Taxes

Governors and state legislatures appear to have had a substantial meeting of minds on the subject of tobacco taxation. This was the most frequent item among the governors' recommendations and virtually all carried the legislative day.

In 1959 California became the 46th state to join the ranks of states taxing cigarettes (3 cents).[11] During the year 14 states increased their rates, eight by 1 cent; four by 2 cents and one each by 1½ cents, 1¾ cents, and 3 cents. At the close of the year the most frequent rate was 5 cents, distribution by tax rates being as follows:

2 cents	2
3 cents	8
3½ cents	1
4 cents	6
5 cents	17
5½ cents	1
6 cents	7
7 cents	1
8 cents	3

New York, Texas, Vermont and Washington imposed taxes on tobacco products other than cigarettes for the first time, at rates ranging from 15 per cent of wholesale price in New York to 25 per cent in Washington.[12] California, on the other hand, rejected the Governor's recommendation for such taxes. Minnesota and South Carolina raised the rates of existing taxes on tobacco products.

Other Tax Changes

A complete inventory of all the tax enactments of the 1959 legislatures would try the patience of the reader no less than the endurance of the writer. However, a few items of miscellany should be recorded.

Pari-mutuel wagering attracted legislative attention in several states. The addition of Nebraska and Vermont raises to 26 the number of those imposing taxes on this form of wagering. At least five of these, California, Michigan, New York, Ohio, and West Virginia, revised their laws to increase revenues. Louisiana effected some rate reduction by replacing its flat rate tax with a graduated schedule.

Minnesota introduced documentary stamp taxes for real estate transfers and Michigan increased the business activities tax from 1½ to 2 mills for public

[11] This count includes Hawaii's 20 per cent tax on wholesale price of cigarettes (approximately 3½ cents). The states without cigarette taxes are Colorado, North Carolina, Oregon and Virginia.

[12] The Washington tax has been held unconstitutional. (Ed.)

utilities and from 6½ to 7¾ mills for other firms. Severance taxes were changed in at least seven states, taxes on insurance companies in at least six and special utilities taxes in four states. The last includes Alaska and Idaho where cooperatively owned enterprises were subjected to the utility taxes.

As a result of 1959 legislation several states move into the 1960's with substantially enlarged revenue producing strength. Others, however, including some industrial states with burgeoning urban centers, face immediate budget requirements in excess of the revenue potential of their present tax structure, presaging legislative tax activity in near future years. Some of that activity is likely to focus on expanding the taxing resources of local governments. In this respect 1959 was strikingly barren especially in comparison with earlier years. Striking also is the absence of property tax legislation, particularly because earlier in the decade some legislatures appeared to be making progress in forcing property tax improvements on local governments. The political reluctance to lower assessments on state assessed properties, notably railroads and other public utilities, and to increase assessments on homeowners, local businesses and other locally assessed taxpayers,—frequently involved in statewide equalization—appears to have effectively slowed the improvement of property assessments, despite the growing realization that it is essential both to the effective utilization of the local jurisdictions' own tax source and to the attainment of the states' grant-in-aid objectives. Increasingly, the problems of state finance center on strengthening the finances of locally administered programs.

THE ORIGIN AND SURVIVAL OF TAX-EXEMPT SECURITIES

GEORGE E. LENT *

UNDER the Articles of Confederation the Congress had no power to levy taxes; it could only make requisitions upon the states which alone possessed the power to tax. The unfortunate history of these "requisitions," which the states honored or ignored at their will, made it clear that the federal government could not remain dependent upon their beneficence.[1] The Constitutional Convention accordingly voted unanimously to grant Congress the power to levy taxes upon individual citizens. Article 1, Section 8, gave the Congress the power to " lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare." However, among other restrictions, Congress could not impose a direct tax without apportionment among the states according to population.

This article traces the tortuous history of this federal taxing power with respect to obligations issued by the states and their instrumentalities.

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[1] This general opinion is best summarized in a letter of Washington to John Jay, August 1786: "Requisitions are a perfect nullity, where thirteen sovereign, independent, disunited States are in the habit of discussing and refusing compliance with them at their option. Requisitions are actually little better than a jest and a by-word throughout the land." *The Writings of George Washington,* edited by Jared Sparks, Vol. IX, p. 188 (Boston: 1835).

I. DEVELOPMENTS BEFORE 1913

The Doctrine of Intergovernmental Immunity

In 1819 the national government's supremacy in the exercise of its express powers was firmly established in a case which greatly influenced the course of future intergovernmental tax relations. This was the famous case of *McCulloch* v. *Maryland,*[2] which arose over the power of the State of Maryland to tax notes of the Second Bank of the United States, recently chartered by the federal government. Following a reverse in the state court, the Bank appealed to the Supreme Court of the United States. All counsel were agreed that the crucial question for decision was whether or not the states possessed the power so to restrict the functions granted to the federal government by the Constitution. In a unanimous decision the Supreme Court upheld the supremacy of the laws of the United States, with the well-known pronouncement, "That the power to tax involves the power to destroy " is a proposition " not to be denied." However, it seemed clear from the decision that the states were not deprived of their original power to tax if it were exercised in a non-discriminatory manner.

[2] 4 Wheat. 316 (1819). For an excellent account of the development of the legal doctrines in this area see B. U. Ratchford, "Intergovernmental Tax Immunities in the United States," *National Tax Journal,* Vol. VI (December 1953) pp. 305-332.

Subsequent decision of the Court sustained the opinion in *McCulloch* v. *Maryland* where a state tax was imposed on a federal instrumentality.[3] But unlike the McCulloch opinion, the decisions do not appear to have revolved upon the discriminatory nature of the tax. To invalidate a tax it was sufficient to declare that the power to tax the operations of a federal instrumentality did or did not exist. As Justice Marshall stated in the case of *Weston* v. *City Counsel of Charleston:* " If the right to impose the tax exists, it is a right which in its nature acknowledges no limits. It may be carried to any extent, within the jurisdiction of the State or corporation which imposes it, which the will of each State and corporation may prescribe." This point of view was clearly established in a subsequent case invalidating a nondiscriminatory tax on offices of profit imposed by the State of Pennsylvania on a captain of a U. S. revenue cutter.[4]

In financing the Civil War Congress entertained few if any doubts about its authority to impose taxes upon income from state and local governments. In fact, the enactment of an income tax was urged as the only practicable means of assessing state office holders (and thousands of others employed on a fixed salary), " most of whom," Rep. Morrill charged " would not contribute a penny unless called upon through this tax." [5] But Congress' power to tax the salary of a state officer was challenged in 1870 by Judge Day of the Massachusetts Court of Probate and Insolvency. The Supreme Court ruled, in *Collector* v. *Day,* that such a tax was invalid because it fell upon the right of the state " to administer justice through the courts." [6] Reasoning from the position previously taken with respect to the immunity of a federal employee from a state tax,[7] the court held that the federal government's taxing power over the exercise of a state's reserved powers was no less restricted. This was the first explicit limitation upon the federal taxing power, which was to have an important influence on the future exemption policy of the federal government.

The Income Tax of 1894

Populist demands for the enactment of a federal income tax culminated in an income tax bill which was incorporated as part of the Tariff Act of 1894. The only exemption from tax was for " salaries due to State, county, or municipal officers," out of deference to *Collector* v. *Day.* Attempts to exclude interest on state and municipal securities were unsuccessful. The original bill recognized no such exemption, and the question of their taxation was not even raised in the long House debate.[8] In the Senate, however, amendments were introduced, first, to exempt interest on state and municipal securities, and second, to exclude only state securities; but these were defeated.[9] To the charge that *Col-*

[3] *Osborn* v. *United States Bank,* 9 Wheat. 738 (1824); *Weston* v. *City Counsel of Charleston,* 2 Pet. 449 (1829).

[4] *Dobbins* v. *The Commissioners of Erie County* 16 Pet. 435 (1842). See also *Bank of Commerce* v. *New York City* 2 Black 620 (1862).

[5] *Congressional Globe,* March 12, 1862, 37th Cong., 2nd Sess., p. 1196; see also speech of Senator Sherman, January 25, 1871, *Cong. Globe,* 41st Cong., 3rd Sess., App. p. 58.

[6] 11 Wall, 113 (1870).

[7] *Dobbins* v. *Commissioners, supra.*

[8] U. S. Department of Justice, *Taxation of Government Bondholders and Employees* (Washington, Government Printing Office, 1938) p. 108.

[9] *Congressional Record,* 53rd Cong., 2nd Sess., pp. 6810, 6820, App., Vol. 6.

lector v. *Day* was violated it was replied that the tax did not rest upon any official office which could be destroyed thereby, but upon the personal property of individual owners which could be taxed in the same manner as other private property.[10]

The new income tax was immediately challenged in the courts by Pollock, a stockholder in the Farmers' Loan and Trust Company. The Supreme Court, in its first opinion, held (1) that the tax on income from real estate was a direct tax and therefore invalid because of failure to apportion it among the states; and (2) that the tax on state and municipal bond income was "a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution." [11] Although the Court was split on the first point, it was unanimous in the matter of state immunity from federal taxation.

Because of the Court's failure to come to a decision on other points at issue, the case was reopened. The second decision confirmed the first with respect to the invalidity of the tax on state and local bond interest,[12] but departed from the Court's previous reasoning. The Court lumped the taxes on state and local bonds with those on other personal property as direct taxes subject to apportionment. But it appeared to reject the immunity rule to which the majority of the Court previously subscribed. This apparent shift in reasoning was significant for the question raised in later years of whether the Sixteenth Amendment effectively removed the constitutional barriers to the taxation of income from states and municipalities. If the immunity theory did not govern, repeal of the apportionment requirement for direct taxes would open the way to the taxation of income "from whatever source derived."

The Sixteenth Amendment

Following repeal of the ill-fated income tax of 1894, a movement for progressive income taxation crystallized into a strong political issue.[13] In a message to the Congress, on June 16, 1909, President Taft called both for an excise tax on corporations, measured by net income, and a joint resolution for a constitutional amendment which would confer "the right to levy and collect an income tax upon the national government without apportionment among the States according to population." [14] The resolution for the income-tax amendment was approved overwhelmingly in July of that year for submission to the states. The Sixteenth Amendment was duly ratified by the requisite number of states and proclaimed to be part of the Constitution on February 5, 1913. According to its provisions: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census of enumeration."

Adoption of the Sixteenth Amendment cleared the way for the introduction of an income-tax bill. This was approved on October 3, 1913, to become effective November 1 of that year. De-

[10] *Ibid.*, pp. 6804-14.

[11] *Pollock* v. *Farmers' Loan and Trust Co.*, 157 U.S. 429 (April 8, 1895).

[12] 158 U.S. 601.

[13] For excellent accounts of this legislative history see U. S. Department of Justice, *op. cit.*, Ch. IV; R. G. and G. C. Blakey, *The Federal Income Tax* (New York: Longmans, Green and Co., 1940) Ch. II.

[14] *Congressional Record*, 61st Cong., 1st Sess., pp. 3344-5.

spite the broad grant of authority to tax income "from whatever source derived," Congress excluded salaries of state and local officials and income from state and local bonds. Considerable difference of opinion persisted among the members of Congress over the extent of the power granted by the Sixteenth Amendment, and the debate over its ratification was marked by sharp controversy over its threat to the rights of the states. It was therefore decided not to arouse these antagonisms further. Cordell Hull, in charge of the bill in the House, explained: ". . . it was not the desire of those who have been taking the most active interest in this measure to inject any more constitutional questions or controversies into the bill, especially for the sake of only a few thousand dollars in taxes . . . ."[15] The question therefore appeared to be resolved on grounds of expediency rather than because of any congressional conclusions over the construction of the Amendment itself.

II. THE MOVEMENT FOR REPEAL OF STATE AND LOCAL EXEMPTION, 1918-1930

The Wartime Attack

The Revenue Bill of 1918 marked the first legislative attempt to repeal the tax exemption of interest on state and local securities. The tax-free status of these securities, which amounted to around $6.5 billion, was considered a serious threat to the market for federal securities with any less favorable tax privileges. The House bill placed all outstanding and future issues on the same tax basis then provided Liberty bonds.[16] The Treasury supported this move as a means of protecting the market for Liberty bonds.

The House approved the measure overwhelmingly. Debate revolved principally on the questionable legal authority to tax the states, but the Chairman of the Ways and Means Committee defended the action as the only way of putting it to the test. However, the Senate rejected the proposal to tax interest on securities, although it retained a similar provision taxing the salaries of state and local officials. The House acceded in conference, and the first real attempt to test the legality of taxing state and local securities was defeated.

The Postwar Campaign for Surtax Reduction

The incompatibility of tax-free bonds with high surtax rates provoked a two-pronged attack on the problem in the postwar period. The initial thrust was a reduction in surtax rates, which had reached a wartime height of 70 per cent. Meanwhile sentiment was growing for a frontal attack on the problem through a constitutional amendment that would legally authorize federal taxation of state and local securities.

In his report for 1919, Treasury Secretary Glass emphasized the undesirable effects of tax-exempt bonds on revenues and the diversion of investment from productive enterprise. His proposed solution was a reduction in surtax rates compensated by an increase in normal tax rates so as to bring the normal rate exemption of federal securities into better alignment with the exemption of

[15] *Congressional Record*, 63rd Cong., 1st Sess., p. 1262, App. Vol. 6, Doc. No. 94.

[16] The first Liberty Loan was wholly tax exempt but the Second Liberty Loan Act provided for only partial tax exemption of new issues. For a summary of these provisions see G. E. Lent, *The Ownership of Tax Exempt Securities, 1913-1953*, Occasional Paper 47, National Bureau of Economic Research (1955) Ch. 2.

state and local securities.

The following year Secretary Houston again proposed a general reduction of the higher surtax rates and increases in the lower rates. "The effective way to tax the rich," counseled the Secretary, "is to adopt rates which do not force investment in tax-exempt securities." [17] As an alternative he suggested an ingenious device for limiting the tax rate on "saved" income to 20 percent, leaving higher rates upon income which is spent, wasted, or "invested" in tax-exempt securities. He further endorsed the Treasury's recommendations made in connection with the Revenue Act of 1918 that tax-exempt income be included for purposes of estimating the surtax liability on taxable income. By means of this device taxpayers would not secure a double benefit of escaping taxes on tax-free bonds and of also reducing surtax rates applicable to taxable income.[18] However, the sharp division between the Democratic Administration and the Republican Congress made any such legislative attempt futile.

A special session of Congress was called on April 11, 1921 to consider tax and other changes, but attention to tax-exempt securities was subordinated to more pressing issues of tariff reduction, repeal of the excess-profits tax and consideration of a sales tax.

Nevertheless, Secretary Mellon continued to urge elimination of tax-exempt securities. On January 16, 1922, in connection with the investigation of tax-exempt securities by the Committee on Ways and Means, he stated:

> The most important consideration is that the existence of the growing mass of tax-exempt securities, coupled with the extremely high surtax rates still imposed by law, tends to drive persons of large income more and more to invest in wholly tax exempt securities . . . . The result is to impair the revenues of the federal government and to pervert the surtaxes, so that instead of raising revenue they frequently operate rather to encourage investment in wholly tax-exempt securities, and even to encourage the issue of such securities by States and municipalities. This process tends to divert investment funds from the development of productive enterprises, transportation, housing, and the like, into nonproductive or wasteful State or municipal expenditures, and forces both the Federal Government and those engaged in business and industry to compete with wholly tax exempt issues and on that account to pay higher rates of interest.[19]

One approach suggested by the Secretary was adoption of the proposed constitutional amendment; the other was through reduction of surtax rates.

Failure of Congress in 1923 to approve the joint resolution providing for such a constitutional amendment strengthened the movement for surtax-rate reduction. It was clear, moreover, that a constitutional amendment would affect only future issues and create a greater scarcity value for securities already outstanding. In November 1923, Secretary Mellon announced his plan for reduction of maximum surtax rates to 25 per cent, in addition to reducing the normal-tax rate to 6 per cent.[20] This plan was

[17] *Annual Report of the Secretary of the Treasury*, 1920, p. 37.

[18] *Annual Report of the Secretary of the Treasury*, 1919, p. 24.

[19] Letter of the Secretary of the Treasury, Relative to Tax Exempt Securities, January 16, 1922. *Annual Report of the Secretary of the Treasury*, 1922, p. 320.

[20] Letter to Acting Chairman of Committee on Ways and Means, November 10, 1923. *Annual Report of the Secretary of the Treasury*, 1923, pp. 6-11.

widely popularized as a scientific principle which would equalize the attractiveness of taxable securities with tax exempts. He explained that a combined tax rate of 31 per cent would so reduce the advantage of buying tax exempts as to attract greater capital into business promising only a slightly higher rate—say 6½ per cent against 4½ per cent on tax exempts.[21] Despite the wide publicity given to this "scientific principle" and the support of business and other groups, a coalition of Democrats and the farm-bloc limited the 1924 surtax rate reductions to a maximum of 40 per cent, on incomes over $500,000.

By 1926 a complete victory was won for lowered surtax rates. The Revenue Act of 1926 exceeded even the objectives of the Mellon plan in reducing the maximum surtax rate to 20 per cent, where it remained until 1932. While the problem of tax-exempt bonds provided considerable support for rate reduction, the growing prosperity of the period made tax reductions possible without sacrificing revenue.

The Campaign for a Constitutional Amendment

Paralleling the campaign for surtax reduction was the movement for the abolition of future tax-exempt bonds. This movement appears to have originated in the controversy over the exemptions granted farm-loan associations by the Federal Farm Loan Act of 1916.[22]

[21] See A. W. Mellon, *Taxation: The People's Business* (New York: The Macmillan Company, 1924) p. 82.

[22] Cf. C. O. Hardy, *Tax Exempt Securities and the Surtax* (New York: The Macmillan Company, 1926), p. 12. The Federal Farm Loan Act, approved July 17, 1913, provided for federal as well as state and local tax exemption of all obligations issued by cooperative farm loan associations and private joint-stock land banks chartered under the Act.

Unsuccessful attempts in the courts to nullify the exemption of farm-loan bonds turned the efforts of rival interests to Congress for legislation that would link the taxation of state and local securities with removal of the exemption privilege from future federal farm-loan issues. The conflict of interest injected by this strategy was largely responsible for the failure of the repeal movement.

By 1920 public opinion was aroused against the growing inequities of tax exemption which accompanied the expanding volume of state and local securities at high surtax rates. The Chamber of Commerce of the United States undertook a nation-wide referendum of its members[23] and the National Tax Association passed a resolution against the principle of tax exemption in all its manifestations.[24] The Investment Bankers Association, Savings Bank Association of the State of New York, the Farm Bureau Federation and other organizations presented resolutions against continuation of the practice. Some advocated a constitutional amendment, if necessary, to secure a change in policy.[25]

The Treasury Department had consistently taken a position against the tax-exemption privilege, but it was not until 1921 that it took a public stand in favor of its outright elimination. Meanwhile, Rep. McFadden introduced a joint resolution for a constitutional amendment outlawing exemption of future issues.[26]

In response to a request for an opinion on this measure, the Secretary of the

[23] Referendum No. 34 (Washington, December 17, 1920).

[24] *Proceedings of the National Tax Association* (New York, 1922) pp. 485-494.

[25] Committee on Ways and Means, *Hearings on Internal Revenue Revision*, 1921.

[26] *H. J. Res. 102*, May 3, 1921.

Treasury developed more fully the administration policy of seeking a constitutional amendment to accomplish this purpose.[27] According to the Secretary, any doubts about the necessity of an amendment, rather than statutory revisions, appeared to be removed by the recent opinion of the Supreme Court in the case of *Evans* v. *Gore*.[28] While the decision concerned the taxability of federal judges, the Court indicated in an *obiter dictum* that the federal government had no greater power to tax income "from whatever source derived" than it enjoyed before the Sixteenth Amendment. The Amendment was interpreted as simply removing the constitutional restrictions on the allocation of direct taxes among the states on the basis of population, without affecting the immunities of states and their instrumentalities with respect to taxation by the federal government.

Secretary Mellon emphasized the necessity of providing for reciprocal right of the states and federal government to tax the income derived from future issues of their securities. The following year (1922) Secretary Mellon repeated the recommendation of his predecessor in 1920 that the farm-loan banks' privilege be withdrawn in any event, "in the belief that it is bad public policy to grant tax exemption, amounting in substance to a subsidy from the Federal Government, to private enterprise of this character." [29]

Failure of the Green Amendment

The Committee on Ways and Means held public hearings on the question of tax-exempt securities in January, 1922.[30] Widespread support for their elimination was received from economists, various interested business groups, as well as from the governors of many states. The public-utility interests emphasized their competitive disadvantage in securing capital. The National Association of Real Estate Boards urged that the tax-exemption inducement be taken away from those of large means "so as to let money flow into the ordinary business channels including mortgages . . . necessary to promote building and home owning." [31] The Farm Mortgage Bankers' Association was very critical of the effects of tax exemption in impairing the private supply of mortgage money. The American Farm Bureau Federation and the Grange both opposed the issuance of tax-free bonds, complaining that money from large estates was thereby diverted from farm mortgages. The Investment Bankers' Association also attacked the principle of exemption. There were, in fact, few defenders of tax-exemption policy except by those who sought relief from the high surtaxes and some of the states, who feared an invasion of their sovereignty.

Following the hearings, Representative Green introduced a joint resolution providing for a constitutional amendment that would authorize reciprocal taxation of future issues of government securities by the states and federal government on a non-discriminatory basis.[32] Debate on the measure centered largely on the inequities of tax exemption under high surtax rates. The familiar objec-

[27] Letter of September 23, 1921, *Annual Report of the Secretary of the Treasury*, 1921, pp. 379-380.

[28] 253 U.S. 254, June 1, 1920.

[29] *Annual Report of the Secretary of the Treasury*, 1922, p. 43.

[30] *Hearings on Tax-Exempt Securities, H. J. Res. 102, 211, 231, 232*, 67th Cong., 4th Sess.

[31] *Ibid.*, p. 75.

[32] *H. J. Res. 314*, 67th Cong., 4th Sess.

tions were offered that it would weaken the states and impair their ability to finance essential public expenditures. The strongest attacks, however, were made by those who viewed the measure as a conspiracy against the federal farm-loan system, since future bonds would be denied the benefits of tax exemption. Rep. Hayden, for example, was convinced that "it is aimed directly at the taxation of Federal farm loan bonds." [33] It was also claimed that removal of tax exemption from future issues would enhance the value of existing bonds in the hands of the rich, and operate as a gift to present bondholders. However, the resolution was passed by the necessary two-thirds vote, 223 to 101, on January 23, 1923.[34]

The Senate Committee on the Judiciary opened hearings on the House resolution, February 10, 1923. While nine states declared in favor of the measure, the State of Virginia delivered a forceful attack on its effects in raising the cost of state and local borrowing without compensating advantages from the taxation of federal bonds. To these and other charges, the Treasury made an appropriate reply, but it was ineffective in securing a favorable report. The Committee was divided on the wisdom of the amendment, and the resolution was not reported out to the Senate. Instead, the Senate directed the Federal Trade Commission to make a full study of the relevant facts.[35]

In his message to the new Congress, December 6, 1923, President Coolidge emphasized the urgency of abolishing the right to issue tax-exempt securities. On January 10, 1924, Rep. Green reintroduced his resolution for an amendment,[36] and the Committee on Ways and Means endorsed it. However, serious opposition developed, largely on the score of increased borrowing costs to the states and municipalities. The United States Good Roads Association, for example, contended that the proposed measure would seriously curtail public improvements by raising interest rates at least 1 per cent and creating difficulties in getting popular authorization for new bond issues.[37] The resolution was also strongly opposed again as a conspiracy of the banking interests against the farmers. Rep. Byrnes charged the farm-mortgage companies with responsibility for the measure: "Had it not been for them," he claimed, "there would be no sentiment for this resolution." [38] But an amendment to exclude farm-loan bonds from the provisions of the resolution was defeated. The resolution was itself finally rejected by a narrow margin of the necessary two-thirds vote—247 to 133.

Although attempts continued to be made in Congress to secure a constitutional amendment abolishing tax-exempt securities, the Green amendments of 1923-24 marked the high tide of this movement. Many were skeptical of securing the necessary ratification of the resolution by the states, even if it were passed by the Congress. But probably the most decisive factor was the reduction in personal income-tax rates accomplished during this period. By 1926 surtax rates were lowered to a maximum of

[33] *Congressional Record*, 67: 4, p. 2260 (January 23, 1923).

[34] For an analysis of the votes, see L. Derrick, "Exemptions of Security Interest from Income Taxes in the United States," *Journal of Business*, XIX, No. 4 (Oct. 1956) Parts 2, p. 21.

[35] S. *Res. 451* (Feb. 28, 1923).

[36] *H. J. Res. 136* (68th Cong., 1st Sess.).

[37] *Congressional Record*, 68: 1, p. 2016.

[38] *Ibid.*, p. 2008.

20 per cent, against a maximum of 65 per cent in 1921.[39] The moderation of surtax rates relieved the pressure for reform of tax exemption and sentiment for its elimination was not to arise until the return of high surtax rates in 1932.[40]

III. REVIVAL OF REPEAL EFFORTS, 1932-1940

Senate Proposals for a Constitutional Amendment

Activity picked up in 1932 with five resolutions for constitutional amendment to tax income from government securities, but it was not until 1933 that any legislative progress was made. At this time Senator Tom Clark introduced an amendment to the National Industrial Recovery Act which would tax interest on all outstanding as well as future issues of federal, state, local and territorial bonds. This attempt to tax government bonds by legislative action was undertaken in the belief that the Sixteenth Amendment had removed constitutional restrictions from such action. The Senate accepted the Clark amendment by a vote of 45 to 37,[41] but it was dropped by the conference committee because of its retroactive effect.[42]

In January 1934, Senator Ashurst introduced a resolution to amend the Constitution so as to authorize federal taxation of state and local securities. This proposal was similar to the Green amendments of 1923 and 1924. It was supported by the Treasury[43] and reported out by the Senate Judiciary Committee, but failed to reach a vote.[44] This resolution was reintroduced at the next session but it was amended so as to tax only future issues of *federal* securities. The Senate adopted the amended resolution by a narrow margin; but it was rejected by the House.

The elimination of tax exemption was not made an Administration issue until June 19, 1935, when President Roosevelt, in a special message to Congress on the broad question of tax policy, took a public stand on the question. "I renew . . . at this time," he stated, "the recommendation made by my predecessor for the submission and ratification of a constitutional amendment whereby the Federal Government will be permitted to tax the income on subsequently issued State and local securities and likewise for the taxation by State and local governments of future issues of Federal securities."[45] He did not press the issue, however, and action on tax-exempt securities awaited other reforms in the tax structure.

The Switch to Legislative Action

Up to this time it was generally believed that the federal government could not tax interest on state and local securities without amending the Constitution. Between 1932 and 1937 no less than 80 resolutions for a constitutional amend-

[39] It is also suggested that the publication of Hardy's study, in 1926, dispelled the idea that government revenues were lost through tax exemption. (See L. Derrick, *op. cit.*, p. 22.) These estimates rested upon rather tenuous assumptions, and were much criticized. Cf. H. C. Simons, *Personal Income Taxation* (1938), p. 175; C. Heer, "Review of Hardy's Tax Exempt Securities and the Surtax," *Political Science Quarterly*, (June 1926) pp. 271-280.

[40] The year 1930 was notable for the absence of any resolution for a constitutional amendment to tax income from government securities, and in the year 1931 only one move in this direction was made. L. Derrick, *op. cit.*, Appendix, Table 14.

[41] *Congressional Record*, 73: 1, pp. 5420-21.

[42] *Ibid.*, p. 5857.

[43] Letter to Chairman, Senate Judiciary Committee, March 8, 1934.

[44] *Senate Report, No. 738 on S. J. Res. 7.*

[45] *House Document, No. 229*, 74th Cong., 1st Sess.

ment to accomplish this purpose were introduced in the Congress.[46] The shadow of the *McCulloch* and *Pollock* decisions still lay over the Congress despite the provision of the Sixteenth Amendment which authorized the federal government to tax income " from whatever source derived." While it seemed clear to many that this phrase meant literally what it said, others pointed to the apparent *intention* of the amendment, as reflected in the debate of the time, simply to repeal the restrictions on the apportionment of direct taxes among the states with regard to population, without conveying any additional taxing power which might impair the sovereignty of the states. The latter position appeared to be supported by the *obiter dicta* of the court in *Evans* v. *Gore*, and the Treasury was inhibited in this belief, although the Court decision itself rested on other constitutional grounds. The fact remained that the question of federal power to tax income from state and local securities had not been squarely placed before the Supreme Court since 1894, in the Pollock cases, and could not be presented so long as the Congress expressly provided for their exemption by statute.

The Administration's move to accomplish the reform by legislative means gave new impetus to the elimination of tax exemption. In a message to Congress, April 25, 1938, President Roosevelt called attention to the menace of tax-exempt securities to the fiscal systems of both the states and the federal government, and maintained that a " fair and effective progressive income tax and a huge perpetual reserve of tax exempt bonds cannot exist side by side." [47] He questioned the assumption that Congress was obliged to wait upon the " cumbersome and uncertain remedy " of a constitutional amendment to accomplish their elimination, and called upon Congress to take effective legislative action, instead. Evidence of a shift in judicial opinion raised the hope that the tax immunities were " not inexorable requirements under the Constitution but are the result of a judicial decision."

The Senate established a special committee, composed of three members each of the committees on Finance and on the Judiciary, to make a thorough study of the problem and recommendation for future action, by March 1, 1939.

The Public Salary Tax Act of 1939

Shortly following this message the Administration's hopes were further encouraged by a favorable decision in the Gerhardt case, involving employees of the Port of New York Authority.[48] In this case the Supreme Court upheld the right of the federal government to levy a nondiscriminatory tax on the salary of a state official, thereby removing any doubts about the *Evans* v. *Gore* dicta. In this decision the court put at rest the argument that the states would be protected against the imposition of such an economic burden by the federal government. In essence, the decision stated that " the State and National Governments must co-exist. Each must be supported by taxation of those who are citizens of both. The mere fact that the economic burden of such taxes must be passed on to a State Government and

[46] See L. Derrick, *op. cit.*, Appendix, for a compilation of these resolutions.

[47] See S. *Res.* 303, 75th Cong., 3rd Sess.

[48] *Helvering* v. *Gerhardt* 304 U.S. 405 (May 23, 1938); rehearing denied, 59 Sup. Ct. 57. This decision was followed in 1939 by a similar victory for the states which expressly overruled the *Evans* v. *Gore* dicta. *Graves* v. *O'Keefe*, 306 U.S. 466.

thus increase to some extent, here wholly conjectural, the expense of its operation, infringes no constitutional immunity. Such burdens are but normal incidents of the organization within the same territory of two Governments, each possessed of the taxing power."

As a result of the decision, the Public Salary Tax Act of 1939 was enacted, April 12, 1939, but further action on the securities question was delayed by extended public hearings.

Congressional Hearings on Tax-Exempt Securities

The special Senate committee opened hearings on January 18, 1939.[49] The Treasury's support for taxation of state and local securities was well documented by a special study of the Department of Justice.[50] The Conference on State Defense, composed of the attorneys-general of 41 states, attacked these constitutional and legal arguments. The economic brief, prepared by Professor H. L. Lutz, carried the main burden of the states' fiscal and economic case. The U. S. Conference of Mayors, the American Municipal Association, Municipal Finance Officers Association, various independent government authorities, and other local organizations also testified against the proposal.

The Treasury opposed the tax-exemption policy on equity, economic, and fiscal grounds. The states rested their case against repeal of tax exemption primarily on grounds of its discriminatory effects. Thus, while the Treasury minimized the " fiscal effects " of the removal of tax exemption, the states succeeded in making this the central issue upon which the controversy and final decision appeared to turn.[51]

The Special Senate Committee was divided in its report.[52] A majority of four concluded: " There should be in our opinion no more tax exempt bonds." However, they opposed any attempt to tax outstanding bonds, and approved continued exemption for refunding issues, to the maturity date of the original issues. A minority of two was of the opinion that " this proposal is economically unsound and that it is unconstitutional. Though it has been popularized with the public as a device to obtain additional taxes from the wealthy, it would in reality place on the States, and particularly upon the cities, a heavy burden of increased local taxation." [53]

Defeat of the Public Bond Tax Act of 1940

On September 14, 1940, Senator Brown, Chairman of the Special Senate Committee, introduced an amendment to the pending revenue bill providing for reciprocal taxation of interest on future issues of federal, state and local securities, known as the Public Bond Tax Act of 1940.[54] Senator Austin, author of the minority report, carried the burden of the opposition. Its defeat by a vote of 30 to 44 brought to close one of the most bitterly contested episodes in the

49 U. S. Senate, Special Committee on Taxation of Government Securities and Salaries, *Hearings on S. Res. 303* (75th Cong.) 1939.

50 *Taxation of Government Bondholders and Employees, op. cit.*

51 Debate was continued along the same lines in hearings held by the Committee on Ways and Means the following June and July. U. S. House of Representatives, Committee on Ways and Means, *Hearings on Proposed Legislation Relating to Tax Exempt Securities* (75th Cong., 1st Sess.) 1939.

52 *Senate Report No. 2140*, 76th Cong., 3rd Sess. (September 18, 1949).

53 *Ibid.*, Part II, p. 1.

54 H.R. 10413, Title VI, *Public Bond Tax Act of 1940*. See *Cong. Rec.*, 76: 3, p. 12185.

movement for elimination of tax exemption. It appears from the debate that the move was defeated less on constitutional grounds than by the effective demonstration of its alleged discriminatory effects on the financing of state and local governments. Equity and economic arguments of the Treasury failed to surmount the well-organized opposition of the states and localities on grounds of fiscal discrimination.

IV. WARTIME EFFORTS TO REPEAL TAX EXEMPTION

Proposal for Retroactive Taxation Defeated

With the formal entrance of the United States into the war the campaign for taxation of interest on state and local securities was reopened with new vigor. In a speech at Cleveland, on January 24, 1942, Secretary Morgenthau pointed up the several major loopholes in the tax system whose inequities were intensified by the greatly increased tax burden imposed by wartime requirements. Here, for the first time, he proposed the taxation of outstanding as well as future issues, estimated at $200 million annually.

In supporting this proposal before the Ways and Means Committee in connection with the Revenue Act of 1942, the Secretary emphasized the revenue loss and the increased stimulus to tax avoidance by the high wartime rates.[55] He defended the retroactive provision by the fact that ownership of outstanding tax-exempt securities, which were not bought in anticipation of high wartime tax rates, resulted in substantial windfalls and accentuated inequities in the distribution of taxes. He contended that removal of tax exemption would not reduce state and local sovereignty and would result in only moderate increases in the cost of state and local Government. The constitutionality of the move was also defended.[56]

This proposal for the taxation of previously outstanding as well as future issues injected a new element of controversy in a matter that was already highly charged. It was assailed by the Conference on State Defense as well as by various municipal associations and municipalities.[57] The Committee, in rejecting the proposal, apparently was persuaded that their taxation would be bad on at least two grounds: (1) It would shift the burden from the federal government to the states and political subdivisions, with no economic gain; (2) in so shifting it would hurt most the small property owner and the tenant who rents property. The familiar constitutional issue of state sovereignty was also raised.[58] It was also felt that taxation of outstanding issues violated a moral obligation of the federal government.

The Revenue Bill of 1942 passed the House without any provision for taxation of state and local securities. The Senate Finance Committee amended it to limit the statutory exemption of interest on state and municipal securities to those issued before January 1, 1943, since it was divided over the question of authority to tax outstanding issues. But on the Senate floor, a successful amendment was introduced to strike out the effective date of exemption and thereby continue the existing exemption policy.[59]

[55] Statement of Secretary Morgenthau before the Committee on Ways and Means, March 3, 1942, *Hearings on Revenue Act of 1942*, p. 2.

[56] Statement of Randolph E. Paul, Tax Advisor to the Secretary of the Treasury, *op. cit.*

[57] U. S. Senate, Committee on Finance, *Hearings on Revenue Act of 1942*, pp. 539-572.

[58] *Congressional Record*, 77: 2, p. 6274, 6374.

The Port of New York Authority Case

In the preceding year the Bureau of Internal Revenue had instituted the first of a series of test cases "intended ultimately to prove in the courts that the Federal Government has the right under the Constitution to tax income from State and municipal securities."[60] Notices of deficiency were sent to seven bondholders of the port of New York Authority who failed to include interest received on their bonds in their income-tax returns filed March 15, 1938. Similar action was taken against two bondholders of the Tri-Borough Bridge Authority. Six of the Port of New York Authority bondholders paid the deficiency but the seventh filed an appeal. The case was heard before the U. S. Tax Court early in 1943.[61]

The government sought to show that the Port of New York Authority was not a political subdivision of a state for tax purposes, and therefore not entitled to tax exemption. Support for this position was implied in the *Gerhardt* opinion which expressed the view "that employees of the Port Authority are not employees of the State or a political subdivision of it within the meaning of the regulations originally promulgated." However, the Tax Court decided that such districts had long been recognized as government instrumentalities and were long acknowledged by the law and regulations to have tax-exempt status.[62] The Court of Appeals sustained the Tax Court and the Supreme Court denied certiorari.[63] The government was thereby blocked in the next move it intended of challenging the immunity of the Authority on general constitutional grounds.

V. POSTWAR DEVELOPMENTS

Public Housing Authority Bonds

The tax-exemption issue lay dormant then until after the war. In 1949 the Administration renewed a proposal for a public-housing construction program, subsidized by the federal government, to provide slum clearance and low-cost housing for lower income groups. The Housing Act of 1949 authorized the payment of subsidies to local public-housing authorities that could in turn be pledged as security for local-housing-authority bonds. It amounted virtually to a federal guarantee which enabled the housing authority bonds to be sold at minimum interest rates.

The Administration bill provided that interest on these bonds be made subject to federal income tax.[64] The American Municipal Association was the principal opponent of this administration move. It claimed that the interest cost would be raised from ½ to 1 per cent, thereby increasing the cost of low-rent housing and necessitating greater federal subsidies, and challenged the constitutionality of the proposal.

[59] The amendment was adopted by a vote of 52 to 34, primarily on the grounds that exemption of future issues would bring in little revenue and could not therefore be justified as a war measure. *Ibid.*, pp. 7888-912, 7919-49.

[60] *Annual Report of the Secretary of the Treasury*, 1941, p. 47.

[61] *Estate of Alexander J. Shamberg, deceased, Isidor W. Shamberg, Administrator, Petition v. Commissioner of Internal Revenue, Respondent.* Docket No. 107713. Transcript of the testimony was published by the *Bond Buyer*, April 24, March 1, 8, 15, 17, 1943.

[62] *Shamberg* v. *Commissioner*, 3 T.C. 131 (January 28, 1944).

[63] *Commissioner* v. *Shamberg's Estate*, 144 F.2d 998 (1944). *Cert.* denied, 323 U.S. 729 (1945).

[64] S. 138, 81st Cong., 1st Sess., Sec. 505.

The bill's sponsors finally struck the tax clause from the Senate bill on the plea that tax policy was properly within the jurisdiction of the Finance Committee. But, when the bill came before the Senate Finance Committee, no action was taken. The legislation was allowed to pass without any alteration of the traditional tax immunity.

The Revenue Act of 1951

In 1951, after a lapse of 8 years, the Treasury revived the tax exemption issue. In presenting the Administration's tax program to cope with the Korean War, Secretary Snyder conceded that repeal of the exemption was made more difficult by the fact that the cost of state and local borrowing would be increased. He suggested that a reasonable basis could be developed for the taxation of state and municipal securities without unduly burdening these governmental units.[65] A recent study had developed a reasonable basis for such a compromise by means of a federal subsidy to the borrowing government, which would compensate for the loss of tax exemption.[66] However, a well-organized campaign of the states and municipalities effectively blocked this move, and it never reached a vote.

The Attempt on Industrial Development and Housing Bonds

In 1954, the Treasury made another abortive attempt to tax future local housing authority bonds; this died in the Ways and Means Committee.[67] Proposed elimination of tax exemption with respect to certain industrial development bonds met a similar fate. These were obligations issued by state and local governments to finance acquisition of industrial plants. Communities were increasingly using this device to attract industry by passing on their lower interest costs to business in reduced rentals. Despite the extremely limited scope of the Committee's restriction (applying only to *revenue* bonds used to finance *manufacturing* plants), state and local officials attacked it as an opening wedge to complete removal of tax exemption. The Committee chairman attempted to reassure critics that elimination of such abuses would better protect general tax exemption privileges,[68] but the measure was finally withdrawn in favor of a provision denying lessees a deduction for rentals on such properties. The Senate, in turn, struck this provision, and it did not survive the final bill.[69]

Since this episode there have been only ineffectual skirmishes over the tax exemption issue, and no evidence of a serious challenge to the states.

VI. SUMMARY AND CONCLUSIONS

Federal tax exemption of interest on state and local securities, imbedded in the original Income Tax Act of 1913, has survived many organized attempts at repeal. The decision to exempt interest at that time apparently did not reflect the considered judgment of Congress on the intention of the Sixteenth Amendment but rather a desire to avoid further acrimonious debate.

65 Committee on Ways and Means, *Hearings on Revenue Revision of 1951*, Part I, 82d Cong., 1st Sess. (1951) pp. 13-14.

66 L. C. Fitch, *Taxing Municipal Bond Income* (New York and Berkeley, University of California Press, 1950).

67 Committee Chairman Reed announced agreement to tax certain future issues, January 20, 1954, but the Committee later reversed its action.

68 Press Release, January 27, 1954.

69 House of Representatives, *Conference Report on Internal Revenue Code of 1954*, 83rd Cong., 2nd Sess. Report No. 2543, p. 33.

The history of attempts to repeal the statutory exemption dates from World War I. Following the decision in *Evans* v. *Gore*, in 1920, legislative efforts were directed toward adoption of a constitutional amendment that would provide for reciprocal taxation of federal as well as state and local securities. These efforts were defeated. Meanwhile, lowering of high income tax rates, believed largely responsible for the evils of tax-exempt securities, reduced the pressure for their elimination, and legislative efforts were not revived until 1934. But these attempts were uniformly unsuccessful.

The federal case for repeal of tax exemption has been based on its pernicious equity and economic effects. Not only are tax-exempt securities a source of gross tax inequity, permitting avoidance of progressive income taxes; they also tend to distort investors' decision in the allocation of capital to private industry and government. The only mitigation of this tendency is the fact that investors accept lower yield on tax-exempt securities, reflecting the "investment in exemption." The federal government has also contended that there is a net revenue loss to government as a whole because the tax savings exceed the reduced cost of borrowing.

The case of the states rests principally on the plea that repeal of tax exemption would greatly increase their cost of borrowing and thereby interfere with the provision of essential government services. Such increased costs, they claim, would entail undesirable higher property and other taxes on lower-income groups. They also maintain that there would be no net revenue gain since the increased revenue to the government would be more than offset by higher interest costs.

The Constitution has long been a refuge to those who defend present policy. Their argument rests basically on the intergovernmental tax-immunity doctrine, first pronounced in 1819, in *McCulloch* v. *Maryland*, and later confirmed in *Collector* v. *Day*. The only decision explicitly nullifying federal taxation of interest on state and local securities was in 1895, in *Pollock* v. *Farmers' Loan and Trust Company*, before adoption of the income-tax amendment in 1913. Because attempts to remove exemption from the tax statute have been unsuccessful, this decision has never been directly challenged.

Since then a distinct shift in the position of the Supreme Court in related areas has convinced many authorities that state and local securities no longer enjoy Constitutional immunity from federal income taxation. The Gerhardt decision, in 1938, opened the way to federal taxation of salaries paid by state and local governments. The following year, in *Graves* v. *O'Keefe*, the Court confirmed the right of states to tax federal salaries, and expressly overturned *Collector* v. *Day*. According to one authority: "It would appear that, on the basis of the tests applied in the Gerhardt and O'Keefe cases, the Court would be quite likely to sustain the application of the income tax on the interest on public bonds if such a case were ever before it." [70]

Fundamentally, however, the conflict over the elimination of tax exemption is a test of the separation of powers that underlies our federal system of government. The strength of the states appears to lie less in the ultimate validity of their constitutional immunity in this respect

[70] B. U. Ratchford, *op. cit.*, p. 327.

than in the belief that federal taxation of their securities, even on a nondiscriminatory basis, impairs their sovereignty. So long as Congress *believes* that such taxation threatens " states' rights," continuation of tax exemption seems assured.

THE FUNCTIONS OF TAX TREATIES†

DAN THROOP SMITH *

THE basic objective of tax treaties is to ease the burden of taxation on international income, that is on income, either personal or corporate, arising in one country and going to another country. Originally, treaties were developed to avoid, or reduce, double taxation of the same income. In the absence of treaties, income is likely to be taxed both in the country where it arises and the country to which it goes—at its source and at its destination. Double taxation of this sort, by its extra burden, discriminates against international movements of investments and people. Tax conventions alone, or in conjunction with special statutory provisions, give relief from these double tax burdens. Reciprocity on rules to fix the source of income, and for reciprocal exemptions or credits for taxes paid in the other country are common methods to provide relief. The purpose is to reduce the combined tax to a level which is not higher than that in the country with the higher rate of tax. This is a minimum objective; without relief from double taxation in this way, no treaty can be really worth while.

Tax treaties also contain provisions to reduce the burden of compliance with the taw laws, without any net reduction in actual taxes paid. A country may waive its right to tax income earned by people temporarily present in it. This will not necessarily reduce the total burden, if the country of which the person is a citizen will also tax it at the same tax rate and give a credit for the tax in the country where it is earned. But relief from the annoyance and uncertainty of becoming subject to a tax jurisdiction in a country when one is present only briefly can be a very real relief. The right to tax other categories of income, such as copyright and patent royalties, may also be renounced by the country where it is earned. And types of income involving particularly difficult problems of allocation, such as the profits of transportation companies or motion picture royalties, may be given simplified methods of taxation by treaty which give assurance that complications will not plague activities in later years.

The foregoing types of problems may arise and need solution even if tax rates are identical in both countries. Treaties thus can be very useful between countries with equal rates of taxation, unless all problems have been resolved by simultaneous unilateral action in the statutes of both countries, a most unlikely circumstance. When the tax rates are different in the two countries, the higher rate in the one country will be a barrier to investment and people coming from the country with the lower rate, even though there is no

† Based upon a paper presented at a symposium of the Tax Institute on "The Impact of Taxation on Management Responsibility for Investments and Operation Abroad," December 3-4, 1959. The original paper will be published along with other papers in the Tax Institute symposium volume.

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discriminatory double taxation. Treaty provisions may be used to bring the higher rate down to or at least down towards the lower rate in so far as citizens or investments of the lower-rate country are concerned. A difference in rate poses a real dilemma for the representatives of the high-tax country. Their taxes discriminate against their own country, from the standpoint of foreigners deciding whether to enter it. A tax reduction is necessary to put their country on terms of tax equality with domestic activity and investment in the country from which they may be seeking people and capital. But a tax reduction in favor of foreigners makes the high taxes discriminate against their own citizens and investors. Attempts to resolve this conflict are as difficult as they are important.

A special case of differences in rates exists when one country gives tax concessions to new industries or investments deemed to be of great importance to their economic development. Under the operation of the usual credit provisions, the tax foregone by the country where the income is earned will simply mean that sooner or later there will be that much less tax credit, and hence that much more net tax, in the country to which the income is sent. This result tends to nullify the tax concession of the country which grants it. This problem also may be worked out by treaty provisions, as part of a comprehensive agreement.

A final subject for consideration in treaty negotiation is the prevention of the evasion of taxes, rather than with relief from undesirable tax burdens. International shenanigans may be even harder for tax authorities to unravel than domestic ones, and exchanges of information may be mutually helpful in the interests of the integrity of both tax systems. Where standards of enforcement are substantially similar in both countries, the equities in favor of an exchange of information seem clear.

These then are the principal problems with which tax treaties are concerned. Each of them is analyzed in more detail in later pages. It is apparent that treaties may go far beyond the reduction or elimination of double taxation, strictly defined, and become effective instruments in furthering an international economic community. The extent to which they give more than the minimum of relief from double taxation is indicative of the breadth of view with which the tax treaty negotiations are approached and perhaps of the real willingness to create conditions conducive to private economic development.

Reduction of Double Taxation

A new interest in tax conventions comes from countries in Latin America, in Asia, and in Africa which realize that reasonable tax treaties may be useful elements in an environment designed to encourage economic development, especially as they recognize that international investment and a relatively free flow of administrative and technical personnel are normal features of the economic relationships of fairly well developed countries and that they can be of particular assistance to developing countries.

It is significant that tax conventions first came into use between countries with advanced economies; they were necessary to help keep taxation, under the higher tax rates, as they were then regarded, after the first World War, from unduly restricting the sort of international investments and movements

of personnel which were basic in the existing order. It is natural that countries aspiring to become full partners in the international economic community should see the value for treaties.

The need for tax treaties between any two countries depends, of course, on the extent of economic intercourse between them and on their respective tax laws. We shall assume enough of the former, at least potentially, to justify treaties between ourselves and all other countries in the free world. It is possible that countries will unilaterally provide definitions of income, establish source rules, and provide for credits of taxes paid abroad by its citizens and residents to such an extent that a treaty can do little more than ratify, and perhaps advertise, what is already available under the respective laws of the two countries. The United States by its generous statutory provision for credits of foreign taxes has, for example, gone a long way in the elimination of double taxation by its own action, and has thereby, incidentally, foregone a bargaining point in treaty negotiations which some other countries have reserved to themselves.

In some instances the tax rates are so low, the definition of income so restricted, and the source rules so circumscribed that no significant tax problems arise for foreign capital or personnel. This is the case in Hong Kong, and is merely one feature of what appears to be the most salubrious tax climate in Asia, if not in the world, except for those isolated tax havens whose principal products are corporate charters and postage stamps.

It is unfortunately true that in many countries most desperately in need of economic development, tax rates and income concepts are such that taxation is a real barrier to foreign investment and other aspects of normal economic relations. In the absence of statutory revisions, which may be contrary to national policy or impossible politically, tax conventions, embodying reciprocal agreements on various matters of rates and source, may significantly reduce and even remove tax barriers. If tax rates are similar, double tax problems arise only in connection with definitions and source rules. Reciprocal clauses on permanent establishments, and other matters pertaining to source, including those relevant to transient individuals and those temporarily present in countries other than their own, will resolve most of the problems of international double taxation. In substance what is needed is agreement as to which country will have the primary right to tax the various categories of international income, with collateral agreements that the country with the residual right to tax will give credit for taxes imposed by the country of source which has the aforementioned primary right.

The concepts of source in some countries are internally inconsistent, in the sense that if universally applied they would make double taxation very general indeed. It is not logical, for instance, to hold that income paid from a country for professional services rendered in another country by people who have never even entered the country from which they receive payment should have its source and be taxable primarily in the country from which the payment is made. It is almost universally recognized that a resident citizen carrying on all his activities at home, as an architect in Chicago for example, is taxable on all his professional income in his country of residence-citizenship. If other countries in which

his designs are used and from which he receives payment assert a right to tax those payments, there will be double taxation; the country of residence-citizenship cannot be expected to forego its own primary right to tax by giving a credit. It might be, of course, that there was general recognition of source of payment as a primary rule, but this is not the case and even those who assert the source rule also inconsistently assert the rule of taxing resident citizens on income for services rendered at home even if the source of payment is abroad.

In a similar manner, it may be claimed that all income is attributable to the production of goods. A few countries have even deemed that foreign firms were in some way subject to income taxation by the mere act of purchasing goods for shipment abroad, a tax policy which seems quite incompatible with other policies designed to encourage exports. Similar problems have arisen among the states within our own country and various methods have been used to allocate income from interstate business. The states with little production but good markets emphasize sales; the states with extensive production to be shipped to other states emphasize payrolls and tangible property in their allocation formulae. Model tax laws with similar formulae have fairly well resolved the problems among our own states; the facts that state income taxes are relatively low and deductible in computing taxable income for the federal tax keep the remaining problems bearable. In international matters, with high rates in both countries, the tax barriers arising from varying formulae may be prohibitive, at least to certain natural forms of carrying on business if not to the transactions themselves.

There is no absolute right or truth in particular source rules; on a practical basis, fairly extensive agreement has been reached on a great many points. They should be adhered to in future treaties in the interest of working towards world-wide agreements. The income from services, for example, has its source where the services are rendered; the country of residence may maintain a residual right to tax, subject to a credit for the tax in the country where the income was earned. This sort of residual right does not discourage international movement; it will merely discourage the maintenance of a residence in the country asserting such a right. Production in one country and sale in another gives rise to income in both places, with the total to be allocated between the two in some consistent manner. The preceding sentence must be qualified to exclude the casual sale or the sale by an order from outside; activities within a country are not taxable unless carried on through a permanent establishment, a term which has come to be generally understood by specialists in the field. Purchasing for export, without fabrication, does not give rise to income even when carried on in a permanent establishment. These are among the accepted concepts which have come to be virtually universal and should be regarded as essential in a tax convention.

The concept of permanent establishment is itself in the process of development. The greater the variety of activities which can be engaged in without coming under the definition of a permanent establishment, the less the tax barriers to international trade. An increasingly narrow definition of a permanent establishment permits a greater variety of sales activities without becoming subject to income taxation in a

country. The Fiscal Committee of The Organization for European Economic Co-operation in its excellent work for uniform concepts in income taxation among the member countries of the O.E.E.C. has proposed a narrower definition (that is, a more liberal approach) to the permanent establishment concept than those heretofore used in many treaties. If it comes into use in Europe, as it should in the interests of greater freedom of trade, other countries including the United States should conform their treaties to it.

Reduction of Tax Harassment

Even with agreements which eliminate double taxation in the sense of extra net tax burdens on international income, as already noted, taxes may still be a barrier because of the burden of reporting, paying, and taking credit for taxes in two places. Tax harassment, even though it does not involve an increase in net tax burdens, may still constitute a real barrier to transactions and personal activities. For example, if a corporation president is taxed on an allocated fraction of his annual salary for a three-day stop during which he inquires about business prospects in a country during a round-the-world trip, he and all his acquaintances would doubtless avoid that country for all future time, even though he might be able to take credit for the tax abroad against his tax at home. This was actually attempted within the past few years. In many cases the foreign tax would not be creditable. But, to repeat, creditability would not have relieved the annoyance of calculating and paying a tax which most people would not regard as properly imposed in the first place; the harassment would doubtless have been a real barrier by itself.

The same problem exists for transient businessmen and professional people. Treaty provisions which give exemption for income earned during limited periods, or up to limited amounts, are very useful in removing these tax nuisances which are likely to impede activity, even though in many of these cases the income would be recognized as earned abroad and hence a tax on it would be creditable in the country of citizenship or permanent residence. Liberal exemption provisions on transient business and professional people can do much to facilitate their movement. Even more liberal rules are adopted for students, professors and various sorts of apprentices. Where the country of citizenship imposes its tax on a global basis, as is true in the United States, exemption abroad usually does not give rise to any net reduction in taxes, in the absence of a difference in rates. In some other countries, which have more liberal rules on taxing income earned abroad, even by citizens who are abroad only briefly, an exemption in the country where services are performed may give full exemption. Such a combination of statutory and treaty provisions would go far beyond the tax neutrality which seems to be taken as an implicit major objective of tax conventions. Exemption involves an actual tax subsidy to international income over domestic income in either country. If this is considered improper, the tax exemption of the transient in the country where income is earned may be made conditional upon its taxation in the country of citizenship or residence.

Tax harassment can be significant for business as well as personal income. Casual transactions, which may be of great value in exploring the possibility

of regular and systematic relationships or investments, are likely to be avoided if they lead to involvement with foreign tax jurisdictions. The permanent establishment concept is thus useful to avoid harassment as well as to prevent double taxation.

Where flows of investment, trade, and individuals move in substantially similar amounts in both directions between countries, good-will provisions to give exemption from tax in the country where income would be commonly recognized as having its source may not involve any measurable revenue losses between countries; in this case they are especially acceptable. Unfortunately, in the newly developing countries, the flow of income, small though it is, is likely to be mostly from the less developed to the more developed country. And in these instances the less developed country may be reluctant to give up its right to tax the income of transients either as a matter of principle or because of the net revenue loss involved. These are the very countries, however, which can most benefit from the services of transients or from one-sided investment. The more provisions there can be to remove tax harassment, the more useful a treaty will be in furthering broad national objectives. It seems altogether proper for us to urge that such provisions be included in treaties even though there may be an unavoidable net gain of revenue to our Treasury. Such a net gain may be frankly embarrassing in principle, though the amounts involved will be of very minor significance to us. The embarrassment comes from a possible feeling that we are attempting to drive a hard bargain for revenue purposes, while the real objective is to make the fullest possible use of a treaty to facilitate international economic relations. The extent to which these good-will provisions are included in treaties may be taken as an indication of the breadth of policy considerations involved. If they are absent, the treaty falls far short of achieving the results which it might or should do in reducing tax barriers. But if another country refuses to include them, a treaty which only reduces actual double taxation may still be of use, limited though it is. One can only hope that broader treaties will encourage those countries which insist on limited treaties to reconsider at later dates.

The renunciation of a recognized right to tax goes beyond mere transient personnel and casual transactions. Reciprocal exemption of shipping and aircraft profits is a good example. The objective here is usually to get rid of a difficult problem, often involving the application of cumbersome allocation formulae with real annoyance to both taxpayers and tax officials. If the income will be taxed where the company is incorporated or resides in any case, then in the absence of tax havens, reciprocal exemption of profits derived from shipments or passages to or from particular countries, or on earnings arising within territorial waters, is desirable on grounds of simplification alone. But if another country refuses to agree to the exemption because of a net loss of revenue, it may not be of critical importance. The degree of inadequacy depends on the degree of complexity in computing the foreign tax and the allowable foreign tax credit, and on whether the amount of the foreign tax is within the allowable credit.

The frequent provisions for reciprocal exemption of interest in the country in which it is earned and from which it is paid raises interesting policy con-

siderations. According to virtually all concepts of source, interest may properly be taxed in the country where it is earned and paid. The country of receipt, or of which the recipient is a citizen, may also tax it as part of a global income, subject to a credit for the tax in the country of source. The treaty provisions for exemption by the country of source are intended to remove an annoyance and an uncertainty which may limit international lending, even if the tax is theoretically and momentarily fully creditable. The annoyance comes from being subject to a foreign tax and from the computations and procedures for payment thereof. The uncertainty may be of two sorts. A foreign tax though presently creditable might be raised to higher rates such that the full tax would not be creditable. Full exemption by treaty gives the best possible assurances against such increases. Less obvious is the fact that even a low rate of tax imposed on gross interest may be in excess of the amount of tax imposed at much higher rates on the net income of the lender in his own country. In the absence of a net income, no tax would be creditable and the entire foreign tax would be a net burden.

Countries seriously interested in securing loans from abroad may thus give tax exemption on interest paid to improve their standing. Since lenders, especially institutional lenders whose net incomes are only a minor fraction of their gross incomes, may not know until after a year is over how much of a foreign tax on gross interest is in fact creditable against their domestic tax, they may largely ignore the creditability and insist upon a net interest from abroad in line with that from other comparable risks from domestic and other foreign countries which do not tax interest payments going abroad. Thus tax exemption may actually reduce the cost of borrowing by substantially the amount of the tax foregone, with no net loss to the debtor country. This approach to the subject was the basis for the reciprocal exemption of interest in the tax convention with Honduras. It was proposed by the Honduran delegation to improve the status of their country as a debtor; it was not sought by the United States to secure a small net gain in revenue which might arise. The advantage of a similar provision should be pointed out to other countries similarly situated. It is unfortunate when debtor countries fail to accept such provisions to encourage and reduce the interest cost of loans to them. But it does not seem appropriate for creditor countries to insist upon this provision if it is resented because of the immediate and direct impact on tax revenues.

Provisions to Reduce Tax Burdens in a High Tax Country

Thus far, attention has been given to situations where tax rates are substantially similar in both countries involved in a treaty. The elimination of double taxation, and the reduction of tax harassments are the objectives of tax conventions under these circumstances. When basic rates are substantially different in the two countries, the higher rates in one country are a very real barrier to the investment and the people who might come in from the country with lower tax rates. The barrier is significant where it operates against movements which, as a matter of policy, are desired by one or both countries. Thus, when foreign rates in a country seeking United States investment are

higher than the United States tax rates, the most complete elimination of double taxation and agreement on source rules and definitions still leave the higher rates abroad as a real impediment, both actual and psychological, to investment and activity in the foreign country. Tax conventions may be useful here, though not all countries are disposed to take advantage of the possibilities. A reciprocal limitation or reduction in certain rates will permit the high rate country to bring its rates more in line with those from which it hopes to draw resources. The United States has reduced reciprocally its tax rate on dividends leaving the country in various treaties from the statutory 30 per cent to 15 per cent or 5 per cent on intercorporate dividends.

Comparisons of business income tax burdens are complicated by the different combinations of income, profits and dividend taxes imposed in various countries and the ways in which they are regarded as burdens on corporations as such or as withholding taxes on shareholders. In the last analysis, the total taxes paid on income earned and realized from a foreign country are what finally determine the relative tax status of activities in different countries. Refinements of theoretical presumptions, though important in tax philosophy, are not important to managements concerned with actual investments and the returns thereon from different foreign countries. A division of the total tax into separate taxes on profits and dividends permits more rapid expansion from retained earnings and is attractive in the common types of situations where a local subsidiary is used and expansion through retention is contemplated. But the additional tax on dividends paid to a parent company must not be brushed aside, as is sometimes done in conversations. The ultimate objective is realization of profit, not just increases in asset values, and a combined income and dividend tax in excess of the amount creditable in the home country is a tax barrier, however the total may be divided.

A tax barrier in the form of higher rates may be more than offset by other favorable factors. It is clearly not an insuperable barrier. But it is nonetheless a very real one, and it will not be offset by the mere existence of a large population (and hence presumably but not actually a large market) or generalized statements about the desirability of foreign investment (or the duty of foreign capital to lend a hand). Exhortation is not sufficient.

It is understandable that a country may find it difficult to bring a tax rate on foreign corporate income lower by treaty than the rate on its own corporations. It is even more difficult to understand why a country seeking rapid economic growth should ever get its corporate income tax above the levels existing in the countries from which it expects to draw investment in the first place. With corporate income taxation providing such a small fraction of total revenue in most newly-developing countries, the revenue loss from a tax rate which would at least not place the country at a competitive tax disadvantage would be relatively very small and well worth while in the interests of greater investment and expansion.

Where the tax consists of a basic corporate tax plus a tax on dividends or on presumptive distributions from a branch activity, it is reasonable and should be politically feasible to bring the rate on dividends to a point where the combined tax does not impose a net

burden. The tax on dividends paid to a parent company seems a particularly appropriate one on which to give some relief, especially since they are sometimes imposed at differential rates in comparison with domestic distributions. The maintenance of equality of the tax on earned corporate income would be thus achieved.

The tax on dividends paid is sometimes, perhaps most often, thought of as a substitute for tax on ultimate stockholders which may not be feasible. But this approach to a tax on stockholders is bad in two respects, when it is applied to intercorporate dividends to a parent company. It is really a tax on the earnings of the corporation and is regarded as such by management in all its decisions. Also it is not creditable by the ultimate individual stockholders and is therefore an additional net tax burden.

It seems sound policy for a country seeking investment from abroad to have a relatively low tax on retained corporate earnings, a policy also useful to encourage expansion by domestically owned corporations as well, and to keep by statute or by treaty its rate on dividends to parent corporations sufficiently low to give assurance that the total tax will be comfortably within the limits of creditable taxes in the home country of the parent. Since the United States has the misfortune to be subject to the highest corporate tax of any major industrial country which might export capital, if rates in the newly developing countries are kept to a reasonable level from this standpoint with respect to other countries, they should provide a safe margin for United States corporate investment abroad. The 30 per cent withholding tax on dividends here provides a basis for reciprocal reduction on subsidiary-parent dividends by treaty. The fact that there may be little income flow from the United States to the other country, and hence little monetary significance to the reduction by us, should not stand in the way of reduction. The reduction in the country seeking investment is needed there. If a statutory reduction is not possible, the treaty procedure is fortunately available as an alternative.

A much higher rate of tax on resident aliens may also be a major barrier to international business and investment, even to corporate investment through subsidiaries. A limited number of resident nationals from the parent company are a natural and necessary corollary of substantial corporate investment. These nationals must be able to receive at least as much take-home pay as they would earn at home or in most other countries. In some places individual income tax rates have been pushed to even higher rates, in some instances much higher rates, on what we regard as middle incomes than exist here. This can mean that the United States citizens in the country would have to be paid higher incomes, before taxes, than the president of the parent company in order to give the same take-home pay that could be earned at home. A situation of this kind makes taxes a real barrier to entry or continuation in a country. Even if such a salary could be paid without any significant effect on the net profitability of the venture, the idea of such a distorted pay scale is thoroughly objectionable to a top management. The high individual income tax can be an emotional barrier even if not a pecuniary one, and decisions can be controlled on emotional grounds.

No way has yet been found to make treaties useful to bring the individual

income tax rate in a high-tax country down to the levels existing in the countries from which foreign management personnel are likely to come. It is understandable why there will be reluctance to give special treatment to foreign individuals. But the fact remains that the failure to give relief may have a repressive effect far beyond any apparent direct revenue significance. It would be desirable to have an approach to this problem through treaties. In its absence, some informal arrangements are made involving the timing or place of receipt of income. The precedent of the United Kingdom in taxing only earned income received there by alien residents can be followed to great advantage by other countries which are much more in need of aliens than is the United Kingdom. Such a provision in a country's laws makes informal arrangements unnecessary, and in many instances the informal approach is properly ruled out on company or individual policy grounds. Taxation confined to income received may not be good tax policy for a country, but it offers a pragmatic solution to an otherwise intolerable situation, when high individual income tax rates keep out foreign management and the investment which they might manage. It should be approached on that basis.

It has been announced on various occasions that the United States is prepared to give recognition, under proper safeguards and limitations, to tax concessions made by foreign countries to attract new industries or expand existing ones which are of particular importance to economic development. Taxes waived or spared would be included with taxes paid in determining the credit for foreign taxes. Without such recognition, the effect of the foreign tax concession, to the extent that it brings the foreign rate below the United States rate, will be to increase the net United States tax when profits are repatriated from foreign subsidiaries or earned directly by branches.

There is understandable resentment in some foreign countries if their tax concessions are nullified by our laws and if what their treasury foregoes in the interest of economic development goes not for the intended purpose but to increase the revenues of the United States Treasury. It is not up to us to say whether the use of tax concessions abroad is wise or foolish; if other countries in the exercise of their autonomy choose to use them they may properly ask us to take account of them. As a matter of international economic policy, we should consider acceding to these requests as part of a general agreement on tax matters.

Tax sparing, as it has come to be called, should be recognized only with reference to existing laws with definite objective standards generally applied in ways which facilitate new investment and significant economic development. It is likely that in many instances not all of the tax concessions made in foreign countries would meet the standards that we would consider appropriate for recognition. We should guard against manipulations by which rates are raised selectively or even generally with concessions then made purely for the sake of a credit. The danger of inducing foreign taxes to be raised to our level exists, however, to a greater degree by the very fact of our foreign tax credit; the net effect of increases is to transfer revenues from our Treasury to that of a foreign country, and this can come about without being subject to a treaty negotiation and the safeguards that can

be imposed by selective recognition of provisions of an existing law.

Tax concessions may be of two sorts, a reduction in the rate of tax for a specified period and rapid depreciation or special investment allowances. Both may be proper subjects for recognition. The latter are especially appropriate though less common in use. Our own laws are almost notoriously ungenerous in the timing of depreciation allowances; the benefits of more effective allowances in other countries designed to increase productivity should not be denied by us to our companies and their subsidiaries. The differences are largely matters of timing. If we fail to recognize the tax concessions of faster depreciation abroad, we will tax more in early years when there is less foreign tax and tax credit, while in later years the taxes abroad may exceed our tax and involve a wasted credit. This would give a greater total tax burden on foreign income even though tax rates in both countries were the same. Recognition of sparing in this sort of situation is necessary to avoid the sort of double burden on international income discussed as a basic objective of tax conventions.

Prevention of Tax Evasion

The final objective of tax treaties to be considered is that dealing with tax evasion. There are two aspects to this subject; they can both be stated briefly. International tax evasion is as reprehensible as purely domestic evasion; perhaps one might even regard it as doubly reprehensible. The exchange of information relevant to fraud situations generally protects the revenue and helps to maintain taxpayer morale by letting it be known that the burdens generally borne by people within a country cannot be evaded by citizens who wander abroad.

A special situation may exist, however, when one of the two countries is still developing its tax administration and for various reasons falls short of fairly general compliance. There is reason for concern lest such a country expect and receive information on foreigners within its borders which singles them out for a higher standard of enforcement than is generally applicable. The issue here is indeed difficult. No country wants to condone actions of its citizens abroad which fall short of the standards that they would be expected to adhere to at home. But on the other hand, there is a natural reluctance to the overt action which will make one's own citizens subject to more vigorous tax enforcement than applies generally, even if this may be considered a first step in improved administration.

The dilemma posed above may be more conjectural than real, since information is given only in very special cases, as perhaps where fraud is expected by both countries, but the result is sufficiently possible to deserve special attention. Since countries are most concerned with enforcing their own laws against their own citizens, it might be desirable, where appropriate, to limit the exchange of information to citizens of the country requesting it. This would give limited cooperation as administrative procedures were developing without exposing one's own citizens to more onerous treatment abroad. The subject is a delicate one, calling for good-will, understanding, and discretion on both sides.

THE TAXATION OF CORPORATE INCOME IN SWEDEN: SOME SPECIAL FEATURES

MARTIN NORR *

PROBABLY no country has sought more vigorously than Sweden to use taxation as a tool to affect the business cycle. Taxation is not used alone; it is applied in conjunction with other fiscal, monetary and regulatory measures of the kinds familiar in other Western societies. How far taxation may help to insulate a highly developed and export-oriented economy from the effects of international economic fluctuations is a matter of some dispute in Sweden. Nevertheless, Sweden has used pioneering tax devices in an effort, first, to make its economy more resistant to depression, and, second, to influence the timing and character of business investment. In this way it has sought to enlist private capital in the task of leveling the business cycle. This use of taxation has not been limited to the income tax. In an outstanding example of its use of tax policy, Sweden imposed a temporary tax on capital expenditures, the "investment tax," in an effort to hold private capital expenditures within the limit of available resources during the inflationary years of the nineteen-fifties. The repeal of the general sales tax in 1947, as another example, was based at least in part on a desire to hold down costs and prices and thereby to restrain wage increases.

But of perhaps more importance as examples of tax policy are certain features of the income tax laws which give corporate taxpayers a high degree of discretion in determining the amount of taxable profits in any particular year. These provisions, in effect, permit firms to establish substantial tax-free reserves. They were adopted, to a considerable extent, in an effort to influence the business cycle. As refined and developed over the years, they constitute an arsenal of tax devices, probably unmatched elsewhere, which may serve as a fertile source of ideas for anyone interested in the use of taxation to offset cyclical economic fluctuations.

An essential feature of the Swedish devices is the degree of control they give corporate taxpayers over the amount of profit to be reported for tax purposes in any given year. Within a wide area they give taxpayers the option in their own discretion to take larger or smaller deductions in a particular year. To some extent these provisions have been regarded as taking the place of loss carry-overs; although presently under

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consideration in Sweden, loss carry-overs have not yet been permitted.[1] But the impact of the tax provisions in question is far broader than that of loss carry-overs. It is not the loss enterprises but the profit enterprises—a group vastly larger in economic significance—who are primary beneficiaries of the Swedish system of discretionary allowances. As a result the system is sometimes criticized as permitting substantial amounts of corporate profits to escape taxation; this in turn is said to increase the burden of the personal income tax. On the other hand, the system is defended as a source of corporate financial strength and as a contributor to the success of Swedish business on world markets.

Of the income tax provisions in question, three of major importance will be summarized in this article. These are the provisions governing depreciation, the provisions governing inventory valuation, and the provisions permitting tax-free allocations to investment reserves for economic stabilization.

Depreciation

Sweden's depreciation provisions have attracted perhaps the largest share of international attention. From 1938 to 1951 Swedish corporations enjoyed the right of "free depreciation" of machinery and equipment. For tax purposes they were permitted to write off the cost of any piece of machinery or equipment completely at their own discretion and without regard to its useful life: the entire cost could be taken as an expense in the year of acquisition, or any portion taken that year and any other portion taken in any other year. A taxpayer could deduct more in good years, less or none at all in bad. The only restriction was that tax depreciation had to coincide with depreciation taken on the books.[2] As a Canadian commentator has pointed out, this system "would be regarded by most corporate executives as approaching the millenium."[3] While it was in effect, many large Swedish enterprises wrote off their machinery and equipment to zero, or to only nominal values.

Criticism of free depreciation developed as inflation increased after World War II. It was charged that free depreciation gave taxpayers extensive tax credits, a factor which in conjunction with high profits and high tax rates induced them to acquire "depreciation

[1] These provisions have also been regarded as a counterweight to high corporate income tax rates. These, while high, are perhaps not excessive when compared with the rates in force in other highly industrialized countries. The national corporate income tax rate, 50 per cent for the past several years, has recently been reduced to 40 per cent, effective for 1961 and later assessment years with respect to incomes earned in 1960 and thereafter. There is also a local income tax, levied under a uniform national statute and almost wholly integrated with the national income tax. While the rate of the local income tax varies from year to year and from locality to locality within Sweden, it averages from 13 per cent to 15 per cent and is deductible from income for purposes of the national income tax. The local income tax is for all practical purposes the only local tax in Sweden; there are no local sales, property, or other taxes.

[2] In all cases acquisition cost rather than replacement value was the base; the total deducted with respect to any item could not exceed acquisition cost. Since machinery could be written off as rapidly as the taxpayer chose, this ordinarily presented no problem. It should be observed that free depreciation applied only to machinery and equipment, not to buildings; these were subject only to straight-line depreciation at low annual rates. While the majority of large taxpayers used free depreciation, it was not the only system available. There was also "restricted depreciation," essentially straight-line depreciation at rates in the neighborhood of 10 per cent per annum of acquisition cost.

[3] Harvey Perry, Director, Canadian Tax Foundation, in speech at Tax Institute Symposium, Princeton, New Jersey, 21 November 1958.

objects" and thereby to aggravate an already inflationary situation. As a result, provisional limitations on free depreciation were imposed in the early nineteen-fifties. These were followed, in 1955, by the adoption of a new depreciation system effective 1 January 1956. While more restrictive than the system it replaced, it is nevertheless exceedingly flexible. Apart from special incentive provisions which may be available in other countries from time to time to particular taxpayers under special conditions, it is probably the most liberal system available in any country to corporate taxpayers generally.

Under the system adopted in 1955, corporate taxpayers may depreciate machinery and equipment according to either of two methods, book depreciation (*räkenskapsenlig avskrivning*) or planned depreciation (*planenlig avskrivning*). Both methods apply only to machinery and equipment; buildings continue subject to straight-line depreciation at low annual rates. Since most major taxpayers use book depreciation that system will be described first.[4]

A taxpayer using book depreciation is allowed to deduct for tax purposes in any year whatever amount of depreciation he chooses in his discretion to take on his books for that year, provided that this does not exceed the maximum imposed by either of two statutory limits. The first of these, the main or 30 per cent declining balance rule, provides that depreciation taken in any year may not exceed 30 per cent of the total of (1) the book value of the taxpayer's entire stock of machinery and equipment at the beginning of the income year, plus (2) the cost of items acquired during the year, minus (3) adjustments for sales or dispositions during the year. Under the 30 per cent declining balance rule, over half the cost of the stock of machinery may be written off in two years: first year, 30 per cent of 100; second year, 30 per cent of remaining book value of 70, or 21 per cent; total in two years, 51 per cent.[5]

These amounts are only ceilings; in any particular year the taxpayer may take as much less as he deems appropriate, with the result that in the following year, the book value on which the 30 per cent deduction, or any part thereof, may be calculated for that year is correspondingly higher. In all instances, the same amount must be written off on the books as is deducted for tax purposes: hence the name "book depreciation."

While the main rule limits depreciation deductions to a 30 per cent declining balance ceiling, a supplemental rule permits larger deductions in certain circumstances. Under the supplemental rule a taxpayer using book depreciation may deduct in any year, without regard to the ceiling imposed by the 30 per cent declining balance rule, whatever amount is needed to reduce the book value of his entire stock of machinery and equipment to a figure equal to its total cost minus cumulative depreciation thereon at the straight line rate of 20

[4] Before a taxpayer may use book depreciation, he must have the permission of the local tax authorities. In practice, the requirement is not onerous. It requires only a showing that the taxpayer keeps an adequate set of books; this is designed to insure that profits on the eventual sale of any item of machinery or equipment will be reported for tax purposes. A similar requirement had been imposed on those seeking to use free depreciation prior to 1951. Taxpayers qualified to use free depreciation were allowed to use book depreciation without further permission.

[5] The 30 per cent declining balance rate is approximately the rate applicable to an item with a seven-year life and a 10 per cent salvage value.

per cent per annum. Take the simple case of a taxpayer whose entire stock of machinery was bought in year one for SKr 1,000 and who chooses to take only SKr 50 as a depreciation deduction in each of years one, two, and three for a total deduction of SKr 150. At the end of year three the book value of his stock of machinery is then SKr 850. For year four he may take—if he chooses—a deduction large enough to reduce this book value to SKr 200: i.e., to the original cost of his machinery, SKr 1,000, minus depreciation at the rate of 20 per cent per annum for four years, or SKr 800. Thus in year four he may take a depreciation deduction of SKr 650 (SKr 850 minus SKr 200). This would leave a book value of SKr 200 at the end of year four. In year five the taxpayer may take up to 30 per cent of that figure under the main rule, or he may use the supplemental rule permitting a write-down to cost less 20 per cent per annum since acquisition; in this case he could write the book value at the end of year five down to zero (SKr 1,000 minus five years depreciation at 20 per cent per annum) by a deduction of the remaining SKr 200. In this instance, the entire cost of his stock of machinery would have been written off in five years. In all cases, the same method must be applied to the entire stock of machinery: in any one year the taxpayer may not use the 30 per cent declining balance option for some items and the 20 per cent straight line option for others.

Whether a taxpayer seeking maximum depreciation deductions will use the 30 per cent declining balance option or the 20 per cent straight line option in a particular year depends on the rate and timing of his machinery acquisitions.[6] In any event, regardless of the ceilings imposed by the 30 per cent declining balance option and the 20 per cent straight line option, a taxpayer may always take a deduction large enough to reduce the book value of his entire stock of machinery to its actual value. The flexibility of the book depreciation system in giving the taxpayer broad discretion to determine the rate and timing of his depreciation deductions is apparent.

For taxpayers who choose not to use book depreciation, another system is available. This is planned depreciation, essentially straight-line depreciation at rates dependent upon the useful life of the machine in question. In determining useful life obsolescence is one of the factors taken into account. Rates are generally in the neighborhood of 10 per cent straight line, based on acquisition cost. In the case of a taxpayer using planned depreciation—as distinguished from one using book depreciation—depreciation deductions for tax purposes need not coincide with depreciation deductions taken on the books. In any particular year, a taxpayer using planned depreciation has an option to take less depreciation for tax purposes than that required by his depreciation plan; in that case, however, his tax depreciation must coincide with the amount deducted on his books for that year. Depreciation allowances from which the taxpayer enjoys no tax benefit may be carried over to future years. Moreover, a taxpayer using planned depreciation may always take a sufficient deduction to reduce the value of his machinery to its actual value; in this case again, the deduction taken for tax purposes must coincide with deduction taken on the

[6] See the examples in World Tax Series, *Taxation in Sweden*, 7/3.4.

books. Finally, a taxpayer using planned depreciation may, with the permission of the local tax authorities, change at any time to the book depreciation system, with the greater freedom that that entails. Since an essential feature of book depreciation, but not of planned depreciation, is that tax deductions and book deductions must correspond, a change from planned to book requires reconciliation of prior book and tax deductions under special procedures outlined in the tax law.

No depreciation as such may be taken on undelivered items. However, a taxpayer who at the end of an income year has machinery or equipment under purchase contract, but not yet delivered, as to which price declines have already occurred or threaten to occur before the delivery date, may anticipate his loss by taking a deduction for the difference between contract price and market value. In that case, the written-down value of the contract becomes the base for future depreciation deductions when the item is delivered. While not limited in its application to the shipping industry, this provision is of special importance to that industry because of sharp fluctuations in the value of ships and the long lead time required for delivery after award of a building contract. For example, a tax ruling applicable to 1957 held that while no write-off should be allowed in the ordinary case on contracts made in that year for the delivery of ships in 1958, 1957 contracts for delivery of ships in 1959 could be written off by as much as 10 per cent; for 1960 delivery, 15 per cent, and for 1961 or later delivery, 20 per cent. Similarly, a taxpayer who is required to pay an excessively high price for a piece of machinery or equipment, either because it is needed for a special task or to take advantage of a special economic opportunity, or because of temporary shortages or inflated prices, may deduct, for tax purposes, the difference between the excessive price and the normal price of the item. In that case, the price as so reduced becomes the basis for future depreciation deductions. This provision, while of no great current importance, was especially useful to the shipping industry just after World War II, when shortages drove prices to unusually high levels.

Inventory

The range of discretion given to Swedish taxpayers by the depreciation rules is duplicated by a range of discretion at least equally wide given by the rules governing inventory valuation. For many years, the right of free depreciation was paralleled by a free right of evaluation of inventories. The book value of a taxpayer's inventory was accepted for income tax purposes so long as that valuation was in accordance with sound business practice; in practice, valuations as low as 20 per cent of the lower of cost or market were accepted by the tax authorities. The resulting pattern of development followed that already noted in the case of depreciation, with temporary restrictions imposed in the inflationary years of the fifties followed by new and somewhat more restrictive rules enacted in 1955. Even the new rules, however, are extremely liberal; in the perhaps envious words of the Federation of British Industries, they provide "extensive facilities for discounting valuations through the creation of tax free reserves." [7]

[7] Federation of British Industries, *Taxation in the Proposed European Free Trade Area* (2d ed., 1958) p. 136.

Disregarding for the moment interim provisions designed to ease the impact of the new inventory rules, the latter now provide that the valuation of the inventories in the taxpayer's books of account shall govern, subject to certain statutory limitations. Under the main rule the taxpayer may first write off all obsolete or unsalable items in full, and then write down the balance of the inventory by 60 per cent to a floor of 40 per cent of cost or market value, whichever is lower. Cost is determined on a first-in-first-out basis.

The main rule is complemented by two supplementary rules. The first of these is the rule of "comparable value." If the value of the inventory at the end of an income year, at cost or market, and after deduction for unsalable items, is less than the average of the value of the inventory at the close of the two prior years, the "comparable value," the taxpayer may write his inventory down by 60 per cent of that comparable value, rather than by 60 per cent of the value at the end of the income year in question. This may be done even if it results in a deficit in the inventory account or a negative inventory value.

The secondary supplementary rule applies to the valuation of raw materials or staple commodities in the inventory. The taxpayer has an option to value these at the lowest market price in effect during the income year or in any of the nine previous years, reduced by 30 per cent of that amount to give a value of 70 per cent of the ten-year low. If the taxpayer chooses for any year to value raw materials or staple commodities in this way, he may not also use the "comparable value" method; i.e., in any one year he may not take advantage of both supplementary rules governing inventory valuation. In any event, however, a taxpayer who can demonstrate that actual or anticipated price declines warrant a lower valuation for his inventory than that available under the ordinary rules may use that lower valuation for tax purposes.[8]

As in the case of machinery under purchase contract, a taxpayer who has undelivered inventory items under purchase contract at the end of an income year as to which price declines have occurred or threaten to occur before delivery may anticipate his loss by writing down the value of the contract to its actual value.

These liberal inventory valuation rules, although not limited in their application to Sweden's important forest industries, are of special importance to those industries, which require large inventories of raw materials marked by low rates of turnover and sharp price fluctuations.

Despite the liberality of the new valuation rules, enacted in 1955 for initial application to the 1957 assessment year,[9] they were somewhat more restrictive than those which had earlier permitted free evaluation of inventories. No exception was made for inventories which had previously been written down to low levels during that earlier period; in effect the new rules subjected pre-existing inventory reserves to retroactive

[8] Valuation of the investment assets of banks, insurance companies and other financial institutions is governed by special rules rather than by the rules stated in the text. In general, such assets may be written down to levels reasonable in the light of actual or anticipated market values. Under this rule, for example, the share holdings of life insurance companies may be carried at the lower of either (1) cost, or (2) 60 per cent of market. See World Tax Series, *Taxation in Sweden*, 10/5, 10/7.

[9] An assessment year relates to incomes earned in the previous income year.

taxation. To ease the impact of the new rules, interim provisions were adopted to effect a gradual transition to the new rules. Minimum inventory values were set at 20 per cent of the lower of cost or market for the 1957 assessment year and 30 per cent of the lower of cost or market for the 1958 and 1959 assessment years, with the 40 per cent floor applicable for the first time only for the 1960 and later assessment years, relating to incomes earned in 1959 and later years. In 1958 some recession in business was apparent in Sweden, as elsewhere, notably in the export-oriented forest industries. As a result the government proposed that the jump in inventory values from 30 per cent of the lower of cost or market to 40 per cent, scheduled to go into effect for the 1959 income year, be postponed for one year. The Riksdag made the change early in 1959; it was estimated that this one year's postponement of the 40 per cent rule meant a postponement of corporate taxes in the neighborhood of SKr 250,000,000.

Investment Reserves for Economic Stabilization

A dramatic example of Sweden's use of tax policy to stabilize the economy may be found in the rules allowing tax-free investment reserves for economic stabilization (*investeringsfonder för konjunkturutjämning*). These provisions, first adopted in 1938 as Sweden was emerging from the depression, were designed to enlist private capital in the task of leveling the business cycle by providing a tax device which would encourage private corporate savings in years of high profits and private capital expenditure in years of low employment. The governing provisions have been made steadily more liberal since 1938, until at the present time a corporation may deduct up to 40 per cent of its pre-tax profits every year for allocation to an investment reserve. A taxpayer needs no government permission to make such a tax-free allocation. On the other hand, government permission is required before the reserve may be used in a way to give the taxpayer the maximum tax benefit. For many years, the high level of the Swedish economy gave no opportunity to test the impact of the private spending that would follow from the actual use of their tax-free reserves by Swedish corporations. The international recession of 1957-1958, however, led the government to permit corporations to use a substantial portion of their investment reserves. It is too early to analyze in detail the resulting impact on investment and employment. It is perhaps significant, though, that private industrial investment went up by about 10 per cent in Sweden in 1958, at a time when it was declining or at best holding steady in other industrial countries.

The development and enlargement of the investment reserve provisions in Sweden since their initial adoption in 1938 will not be set out here;[10] this article will summarize only the present law. Corporations may now set aside up to 40 per cent of pre-tax net income from business activities as a reserve for future business investment (*investeringsfond för rörelse*). Corporations engaged in forestry may set aside up to 10 per cent of their gross receipts from forestry as a reserve for future forestry investment (*investeringsfond för skogsbruk*). Corporations engaged both in business and in forestry may use both

[10] See World Tax Series, *Taxation in Sweden*, 6/6.2.

investment reserves.[11]

Amounts allocated to an investment reserve are deductible from income for purposes of both national and local income taxes. In every case, however, 40 per cent of the amount so allocated must be deposited to the taxpayer's credit in the Riksbank. The remaining 60 per cent, although it must be charged to the investment reserve on the corporation's books, remains in its hands as part of its working capital. At the time an allocation to an investment reserve is made, no specification of its intended eventual use by the taxpayer is required. There is no limit to the number of years in which tax-free allocations to investment reserves may be made or to the total amount which a reserve may reach.

Control over the corporation's use of its investment reserve is vested in the Labor Market Board. This is the government agency charged with the duty of combating unemployment; it is not a part of the revenue administration. At any time when, in the Board's opinion, the national economic and employment situation warrants, the Board may authorize (or even order) [12] a corporation to make use of all or part of an investment reserve for one of the purposes authorized by the governing statute. In the case of a business investment reserve, these purposes include the construction of buildings, the acquisition of new machinery and equipment, the purchase of inventory, and the development of mineral deposits. In the case of a forestry investment reserve, these purposes include forestry care and development in a broad sense.

When an investment reserve is used for one of these purposes with the permission, or on the order, of the Labor Market Board, the amount so used is not restored to taxable income. However, to the extent an asset or an expense has been charged to the investment reserve, it is not also subject to depreciation or deduction. Since the amount in the reserve has already been deducted from taxable income, double deductions are thus avoided. But there is one exception, and an important one, to the avoidance of double deductions. When a corporation uses an investment reserve with the permission (or on the order) of the Labor Market Board, it receives a special additional " investment deduction " from income of 10 per cent of the amount so used. The provision for an extra investment deduction, new in the 1955 law, was adopted as a " powerful stimulant " to corporations to make use of the investment reserve provision; it was one of the factors which led to a sharp increase in allocation to investment reserves after passage of the 1955 law. If a reserve, on the other hand, is used without permission of the Board, or if an order to use such a reserve is not complied with, the amount involved, plus a penal sum of 10 per cent of that amount, is restored to taxable income. As a practical matter there are no significant cases in which this has occurred.

[11] The investment reserve provisions are available only to corporations (and to certain similar business entities), not to individuals. From time to time their extension to individual taxpayers has been considered. This has been rejected both for administrative reasons and because most major Swedish enterprises are carried on in the corporate form. As a result, it was felt that in the private sector only corporations could make investments large enough to have a significant effect on employment in a recession.

[12] As a practical matter the Labor Market Board has never ordered or required a corporation to use its investment reserve; such use to date has always been at the request or on the option of the taxpayer. No significant change in this pattern seems likely unless economic conditions worsen drastically.

The rule that a reserve may be used only with the permission (or on the order) of the Labor Market Board is subject to a major exception: after five years from the time of allocation to an investment reserve, a taxpayer may use up to 30 per cent of the amount of that allocation—the so-called " free sector " —at his own discretion, without permission of the Labor Market Board and without restoration of the amount involved to taxable income. In this case, however, he is not entitled to the extra 10 per cent investment deduction. The " free sector " provision was also added to the law in 1955 to make investment reserves more attractive to taxpayers; this was coupled with the denial of the extra 10 per cent " investment deduction " to sums drawn from the free sector in order to induce corporations not to take advantage of the free sector but to leave sums in their investment reserves until such time as the Labor Market Board authorized their use, presumably at a time when the economic and employment situations made that use advisable.

In all cases, when an investment reserves is used aliquot portions must be drawn from the amount on deposit in the Riksbank and from the amount retained at the corporation's hands.

The following example illustrates the operation of the investment reserve deduction; it does not take into account the local income tax, which averages from 13 per cent to 15 per cent, and assumes a national corporate income tax rate of 50 per cent (a 1959 law reduced the corporate rate to 40 per cent as of the 1961 assessment year with respect to incomes earned in 1960 and later income years).

Example

Assume that a corporate taxpayer has a pre-tax net business income of SKr 1,000,000. It must pay tax in any event on 60 per cent of that sum, or SKr 600,000, at the 50 per cent rate; this leaves it SKr 300,000 from that segment of its income. As to the remaining 40 per cent of its income, or SKr 400,000, it has two alternatives. First, it may choose to disregard the investment reserve option and to pay income tax at the rate of 50 per cent. In that event, SKr 200,000 will go permanently to the government as tax (in addition to the SKr 300,000 already paid) but the balance of SKr 200,000 will remain in the unfettered disposition of the taxpayer. Second, it may choose to take advantage of the investment reserve option. In that event, 40 per cent of the sum of SKr 400,000, or SKr 160,000, must be deposited in the Riksbank; this remains available for the corporation's eventual use in accordance with the provisions of the investment reserve law. The remaining 60 per cent of the sum of SKr 400,000, or SKr 240,000, is neither paid to the government nor deposited in the Riksbank. It remains in the taxpayer's hands for current use in the business, but must be set aside on the books as part of its investment reserve and is available for permanent disposition only in accordance with the provisions of the investment reserve law. Thus, depending on which alternative it chooses, a corporation with a pre-tax net income of Skr 1,000,000 has an option to pay a tax of either SKr 500,000 or of SKr 300,000.[13]

[13] In proposing the adoption of a similar tax device in other countries, Snider pointed out that " In other words, every dollar the government might forego in tax revenues during prosperous periods would mean, at a 50% tax rate, $2 available to the nation for countercyclical spending in depression years. In effect, business would be matching each dollar contributed to the reserves by tax savings with a dollar of its own money." Joseph L. Snider, " Funds for Stability," *Harvard Business Review* (July-August 1952) Vol. XXX, pp. 86 to 96.

The new and more favorable provisions adopted in 1955, perhaps coupled with the effect of an increase in the corporation tax rate (since rescinded as of 1960) from 40 per cent to 45 per cent and then to 50 per cent, resulted in sharp increases in the amounts allocated to investment reserves. Under the provisions in effect prior to the 1955 law, a total of 630 firms had set aside a total of SKr 247,000,000 in investment reserves. By the end of the year 1958, however, this amount had increased to a total of SKr 1,143,000,000 in investment reserves, set aside by a total of 1,191 different enterprises. The sharp increase after enactment of the 1955 law is attributed to a combination of good business, high tax rates, the more favorable provisions of the 1955 law, and an increasing awareness of the tax advantages offered by the legislation.

Until 1958, however, no permission to use investment reserves was granted by the government. In the light of the excellent state of the Swedish economy and of a resulting tight labor market, there was no need to release investment reserves to stimulate employment. The recession of 1957-1958 changed this situation. As a result, the Labor Market Board announced in May of 1958 that for the first time it would entertain applications for the use of investment reserves for the purposes authorized by the governing statute.

Many such applications were made, virtually all of which were granted. By the end of 1958, the Board had granted permission to charge proposed projects to investment reserves in 264 cases involving 198 different enterprises and estimated expenditures of SKr 250,000,000. In granting permission to use an investment, the Board's chief criterion was the effect of the proposed investment on employment during the winter of 1958-1959. The Board's practice was not merely to allow a certain sum in money to be charged to a reserve; instead, it authorized a particular project of a certain estimated cost, to be begun and completed within a stated time, to be so charged. No permission to charge past investments to the reserves was granted. In no case did the Board require a finding that the project would not have been undertaken but for the availability of the investment reserve.

These projects involved investment reserves set up from business income. In addition, because of a general decline in forest employment, the Board gave blanket permission to use investment reserves set aside from forestry income for the purposes authorized by the 1955 law without special application to the Board. These forestry reserves at that time amounted to about SKr 45,000,000.

With unemployment continuing into 1959, the Labor Market Board continued to authorize the use of investment reserves. By September 1959, the Board had authorized total expenditures of SKr 700,000,000. Most of the projects involved the construction of buildings and plants. In the light of the liberal provisions permitting fast depreciation of machinery and allowing substantial inventory write-downs, there is in fact little incentive for taxpayers to charge acquisitions of machinery or inventory to investment reserves. Such a charge would deprive them of the tax benefits of the ordinary provisions which are available in any case. On the other hand, rigid rules restrict the depreciation of buildings to small annual percentages. Thus virtually all applicants

sought permission to charge the construction of buildings and plants to investment reserves. Such a charge permits the fast depreciation of a building, a tax benefit not available in any other way. Indeed, these provisions permit a pre-expenditure rather than a post-expenditure deduction, in addition to the extra 10 per cent investment deduction available when the reserve is used.

How far the use of investment reserves was instrumental in maintaining the pace of Swedish industrial investment, despite the recession, cannot yet be demonstrated statistically. While it it difficult to estimate how much of the investment made through the use of investment reserves would have been made in any event, the chairman of the Labor Market Board has stated that,

> . . . it is perhaps not being unrealistic to think that a large part of it would have been postponed until better times, when firms would have had a clearer picture of the future. Now, however, a large part of this investment has been undertaken precisely at a time when it has been considered most appropriate from the point of view of employment and the state of the economy. This is the primary value of the investment funds, that they provide a stimulus at the appropriate time. . . . [14]

The Minister of Finance, presumably not one to approve lightly of provisions that result in substantial corporate tax deductions, joined in praising the impact of the investment reserve provisions. In a statement to the Riksdag at the end of 1958, he said:

> The legislation concerning investment reserves has shown itself in the present business conditions to be an effective method of stimulating investment activity and thereby creating increased employment opportunities. On the one hand, the increased deduction that may be enjoyed when the reserve is used has proven to be a stimulant, and on the other hand, the repayment of the amounts deposited in the Riksbank serves to make it easier for firms to finance their investments. The experience gained shows that the legislation on investment reserves is, to a large extent, suitable to the purpose for which it was designed.[15]

The Minister went on to propose some changes to make the law still more useful for its purpose. He pointed out that the Labor Market Board had largely limited its approval to projects to be completed within two years at the most; this in practice put a limit on the size of the project that might be charged to a reserve. Moreover, he added, it was only after the enactment of the 1955 law that the reserve provisions had been used to any considerable extent; as a result, many firms had not yet had time to make allocations to their reserves equal to the cost of major projects. But, he added, it was desirable that large employment-creating projects be gotten underway promptly. This was especially true because such world economic developments as the European Economic Community required that Sweden's export-oriented basic industries be allowed to improve their competitive positions. He therefore proposed to expand the investment reserve law by adding provisions dealing with long-term investments of special importance.

The proposed changes were enacted by the Riksdag in April 1959.[16] In

[14] B. Olsson, "Employment Policy during the Recession," *Skandinaviska Banken Quarterly Review* (April 1959) 54, at 59.

[15] KM Proposition nr 6 år 1959.

[16] KF *angående ändring o förordningen den 27 maj 1955* (nr 256) *om investeringsfonder för konjunkturutjämning,* 3 April 1959 (SFS 1959:69).

summary they provide that in special circumstances industries may obtain permission to use investment reserves, including those to be deducted from income in future years, for major long-term projects. Special limitations on the use of investment reserves for these purposes are imposed; if the use of sums to be set aside in the future is involved, no more than 75 per cent of the project cost may be charged to the reserve, and as to such projects the 10 per cent extra investment deduction is not available. This extra deduction had been established to induce taxpayers to make allocations to investment reserves when timing of the eventual use of the reserves could not be predicted. It therefore seemed inappropriate to permit the extra deduction as to projects for which the taxpayer had received advance permission to use future reserves.

Permission to charge long-term projects to future investment reserves under the 1959 amendments must be obtained from the King in Council—in effect, the Cabinet—rather than the Labor Market Board. Within a few months the King in Council had authorized expenditures of about SKr 315 million under the new provisions. About SKr 235 million of this sum was to come from future reserves, with the balance of SKr 80 million charged to reserves set aside in previous years.

In September 1959, with recovery apparent in both the domestic and export markets, the Labor Market Board announced that for the time being no further applications for the use of investment reserves would be granted. By this time, private industry had been authorized to charge expenditures of more than SKr 1 billion to investment reserves (SKr 700 million by the Labor Market Board, SKr 315 million by the King in Council under the 1959 amendments).

Not enough time has elapsed for full evaluation of the impact of the use of investment reserves in the 1958-1959 period. Nevertheless both government and business circles seem to be of the opinion that they furnish a useful device, perhaps the most effective of all tax devices, to harness private capital in the effort to level off the business cycle. On several occasions the adoption of this Swedish tax device by the United States has been proposed.[17] The Merchant Marine Act of 1936 already permits the shipping industry to establish "ship construction reserve funds" under provisions bearing some resemblance to the general Swedish provisions.[18] Now that the record of Sweden's experience with investment reserves is available, perhaps the time has come to renew consideration of similar reserve provisions for American industry generally.

[17] Joseph L. Snider, "Funds for Stability," *Harvard Business Review* (July-August 1952) Vol. XXX, p. 86. J. P. Shelton, "A Tax Incentive for Stabilizing Business Investment," *National Tax Journal* (September 1956) Vol. IX, p. 232.

[18] Merchant Marine Act of 1936 as amended by Ship Construction Reserve Fund Act of 1940, 54 Stat. 1106, 46 USC § 1161.

FISCAL PSYCHOLOGY: A NEW BRANCH OF PUBLIC FINANCE

G. SCHMÖLDERS *

I

TWO important results of some 1958 surveys conducted in Germany under the auspices of the Cologne Center of Empirical Economics Research in the new line of research on fiscal psychology are: (1) that fiscal policy, the idea of deficit-spending in a depression and surplus-hoarding in a boom, has hardly any chance of practical application because of the general lack of understanding among members of parliament and administrators of the underlying economic and monetary processes; and (2) that " tax-dodging " is something quite unfamiliar to 90 per cent of the German population.

For the first time in history, a representative sample of a whole national parliament, the Deutsche Bundestag, was tested by modern methods of opinion research as to the economic knowledge of its members (67 interviews). In addition, all the members of its finance committee were also examined (27 interviews). At the same time, the attitude of the general public toward taxation was analyzed in a modern survey investigation, carefully conducted by one of the leading public-opinion research institutes of Western Germany. Even this latter type of research, digging down deeply into the motivational and emotional layers of the mind of taxpayers and other citizens, seems to have no precedent in traditional public finance.

In the Old World, the roots of this new branch of public finance go back to the Macchiavellian philosophy of public law. Working along these lines, some Italian authors developed, at the turn of the century, a political theory of government finance, based largely on highly cynical concepts of political and administrative power.[1] One of these authors, Amilcare Puviani, Professor of Law at the University of Perugia, even succeeded in writing a complete " theory of fiscal illusions," in which he contrasted the illusions of taxpayers concerning the noble motives of their rulers with the illusions which the latter held about the loyal feeling of their subjects.[2] In simple hedonistic terms of satisfaction and dissatisfaction, Puviani described most of the phenomena modern fiscal psychology embraces. These include ways of camouflaging taxation under other names, or levying taxes under conditions under which the taxpayer is inclined to minimize or even fail to perceive any burden, e.g., death duties imposed upon heirs. Further, he dealt with the skillful misuse of noble feelings like patriotism, confidence and

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[1] A. Labriola, *Sul Principio regulatore della finanza pubblica*, 1902, speaks of the " arbitrariness and inconsistency " in the ruling power of political authorities.

[2] A. Puviani, Teoria della illusione finanziaria, 1903.

religious faith through the issue of public loans which later might not be repaid, or, if repaid, only in depreciated money. Taxpayers reactions against such fiscal tyranny, including some comments on the social background of revolutions, were also systematically recorded by Puviani years before modern psychology or social psychology had been developed.

Italian fascism and German nazism, though broadening the field of experiences, did not permit scientific research along these lines. Only after the Second World War was it possible to recount such experiences and to formulate in terms and categories of modern psychology the conclusions drawn from Mussolini's fiscal measures and Dr. Goebbels' propaganda.

It is hardly necessary to point out that many of the more traditional rules and principles of public finance are rooted in genuine, if primitive, knowledge of human behaviour. As early as 1728, Jonathan Swift had pointed to certain limits to the raising of customs duties on non-essentials.[3] Even Adam Smith's famous basic principles of taxation were meant to protect the taxpayer against fiscal arbitrariness and injustice. Smith, for some time a customs inspector, knew much about the weakness of human nature under the temptations of power. In the course of the 19th century, French public finance derived some general principles of budgeting from the same experience.[4] The principles of publicity, of completeness, specialization, and truthfulness in budgeting, for instance, are only so many mirrors reflecting suspicion of the integrity, good faith, and fairness of an administration.

Even the economic effects of taxation in general, and of income taxation in particular, have been analyzed in certain behavioral aspects by traditional public finance. The British economist, A. C. Pigou, developed his so-called " tax announcement effects " by showing that taxpayers' reactions against a new tax quite logically start long before the tax is actually levied.[5] Fears of loss and expectations of possible profit are among the factors that lead business men to premature reactions from tax alterations, which have only been proposed or suggested.

It was only a small step from that development for modern fiscal psychology to penetrate more systematically into taxpayers' motivations and reactions. Resistance against and evasion from taxation were studied not only in the field of the income tax, but even in the area of excise, sales and outlay taxation and customs duties. For, even if taxation as such passes unnoticed by the final taxpayer, insofar as the tax is included in the price of the commodity, the elasticity of demand for the product becomes the decisive factor limiting its fiscal results. But what is elasticity of demand? It is, after all, nothing more than a psychic (or even physiological) measure of the urgency of wants.

The main task of fiscal psychology remains, however, to analyze the direct resistance to direct taxation of individuals and nations according to their general " tax mentality." Such tax mentality can be shown to differ widely between different peoples of Europe. Whereas, in the Latin world, the word tax means

[3] J. Swift, An answer to a paper called A Memorial of the Poor Inhabitants, Tradesmen, and Labourers of the Kingdom of Ireland, 1728.

[4] G. Jèze, Le Budget, 1910.

[5] A. Pigou, *A Study in Public Finance*, 1928.

something felt as an " imposition " upon the citizens (*impôt, imposto, impuesto*), the German word, *Steuer,* means " support " and the Scandinavian, *skat,* the common treasure destined for common purposes. On the basis of such different national tax mentalities, which are closely connected with the citizens' community-mindedness in general, individual tax-mindedness develops by personal experiences. Confronted with the obligation to pay, the taxpayer feels inclined to a certain degree of resistance, leading to evasion, tax-dodging, or even to open revolt, like M. Poujade and his followers in France.

In order to measure the degree of individual resistance to direct taxation, two ways are open to the researcher depending upon his access to the individual cases. Measuring tax compliance means to assess, by voluntary cooperation of the taxpayers involved, the correct amount of their statutory tax obligation. Compared with the actual amount paid, a percentage of tax compliance can be determined. In the United States, some experimental research along these lines has been done by Harold M. Groves [6] and G. F. Break.[7] The compliance ratio of rent income (ratio of reported net rent to estimated net rent) varied, according to Grove's Wisconsin study, between 17 per cent (renter subletting) and 78 per cent (garages) with an average of 51 per cent. The compliance ratio of farm income was between 46 per cent (poultry and eggs) and 86 per cent (dairy products), and averaged 75 per cent. Noncompliance by farmers, however, seems to be greater than these figures reveal because of heavy overreporting of farm expenses deductible from reported income. For income other than rent and farm income, similar investigations remain to be carried out.

In most cases, this way will be closed to further research by lack of cooperation on the part of taxpayers or tax-dodgers. Then, the only other way of measuring the degree of negative compliance or tax resistance is to compose a true picture of the tax-mindedness of people by ascertaining its elements. There are certain relations between a person's community-mindedness, generosity in family, club, or social matters, understanding of and cooperation in public affairs, and personal readiness to comply with the painful common obligations of a similar nature, such as tax-paying. Patterns of general tax mentality are discernible on the basis of neighborhood, social class, and profession to which the taxpayer belongs. In other words, the individual citizen or household can be enmeshed in a net of admissions that will add up to a true picture of his personality as a taxpayer. If this so-called projection test is applied, the victim can even be brought to confess his secret opinions on tax-dodging (by others!) and his personal feelings about tax-dodgers as social companions, business partners, or members of his family.

II

A survey concentrating on such a many-sided analysis was conducted, as mentioned above, in the early summer of 1958 in Germany.[8] The " defend-

[6] H. M. Groves, " Empirical Studies of Income Tax Compliance," *National Tax Journal,* December 1958, pp. 291-301.

[7] G. F. Break, " Income Tax and Incentives to Work: An Empirical Study," *American Economic Review,* Volume XLVII, No. 5, September 1957.

[8] G. Schmölders, *Das Irrationale in der öffentlicher-Finanzwirtschaft,* shortly to be published by Rowohlt (Rowohlts Deutsche Enzyklopädie, Bd. 100).

ants," a large representative sample of citizens from all walks of life, were cross-examined by experienced interviewers regarding their general tax-mindedness, their moral assessment of tax-dodging and of fiscal administrators and tax officials. Through most of the interview, the person being questioned had no idea what it all was about. After admitting his viewpoint on the giving of gifts to others, on the assuming of responsibilities by family members and more remote relatives, club members, room- and work-mates, or strangers, etc., he was asked: " Is, in your opinion, the so-called church tax really a tax? Or how would you prefer to define it? "[9]

Most people likened the church tax, which is levied in Germany together with the income tax and by the same authorities, more to a tax than to a voluntary contribution or a fee.

The interviewer could then turn inconspicuously from this question to some more on the difference between taxation and fees, and voluntary contributions. Tax-dodging was introduced in quite neutral terms: " Are there many people, in your opinion, willing and able to keep the fiscal authorities from collecting something legally due them? " The person interviewed was asked to decide on one of two possible viewpoints on tax-dodging: Would he accept or reject a tax-dodger as his business partner, son-in-law, or cashier?

Most people compared tax-dodgers neither with criminals nor with common-sense folks, but with clever business men. But tax-dodging was unfamiliar to most of them. For 90 per cent of the German population, income tax is withheld at the source together with social-security taxes, church tax, and other deductions. Only business men and the professions were held able and willing to dodge their taxes. These groups, in turn, blamed farmers (who actually are practically exempt), but could not help being caught on slippery ground themselves. Another investigation is planned to concentrate on these groups, whose representation in the general population sample naturally was not sufficient for exact conclusions.

III

Another hunting-ground for fiscal psychology is decision-making in parliament, particularly in matters of fiscal law and policy. While in the law field enough experts are at hand (many members have come from the bar or from high functions in administration), questions of fiscal policy do not find competent answers in the German Bundestag. This was proved by a survey concentrating on the unique experiment made involuntarily by the federal government during the years of 1953 to 1958 when a budget surplus was accompanied by a cash accumulation which was later dissipated.[10] Rearmament was planned and budgeted according to Germany's international obligations. But due to difficulties of a more technical nature (like time lags in building and deliberations about weapons) several billions of marks could not be expended in time. These formed the nucleus of a government hoard which accumulated every year up to a total amount of nearly 7 billion marks ($1.7 billions). In the business

[9] As 90 per cent of the German population belong to either Protestant or Roman Catholic denominations, both churches are largely financed by a percentage addition (10-11 per cent) to the General Income Tax of the State called Church Tax.

[10] G. Schmölders, *Die Politiker und die Währung*, shortly to be published by Fritz Knapp, Frankfurt.

world, this accumulation of tax money was criticized quite openly. Some experts compared, somewhat misleadingly, the government hoard with the famous war treasure of the Bismarck Reich, deposited in an old tower of Spandau fortress called "Juliusturm." Even more criticism was directed at the Ministry of Finance, when, amid a business boom and under full employment, the hoard was dissolved and used for a host of new (and permanent!) expenditures. As the billions of government money had been kept in the Central Bank, their expenditure was nothing but creation of money or "deficit spending" in the face of full employment and a general boom.

Very few, if any, of the Members of Parliament confronted with this somewhat complex problem passed the interviewers' examination on its monetary and economic background. Most answers disclosed very little knowledge or understanding of fiscal-monetary relations, the economic consequences of deficit-spending in a boom, or even the difference between budget and cash expenditures. On the contrary, many of the respondents appeared eager to vote new and bigger expenditures according to a long list of priorities. When asked how they intended to cover such expenditures, the answer was mostly "by cutting other budget items." Logically, this would mean either the politicians' neglect or disapproval of former decisions of their own, or a strong preference for "new" instead of "old" functions of the government. Psychologically, it only betrays some of the laws of political thinking and decision-making. These laws seem to include a strong inclination toward impressive catchwords and stereotypes as well as quite uniform reactions to some of the more emotional issues. The question whether there still exists real poverty in Germany in a considerable degree was mostly answered in the affirmative, notwithstanding a nearly unanimous approval of the catchword "economic miracle," and the admission that even the little fellows had duly participated in it. Even the catchword "Juliusturm" confirmed these laws of political thinking very convincingly. Everybody knew something about the Juliusturm and criticized its accumulation. Such criticism, in the minds of politicians, was bound to assume the form of approval for the hoard's immediate dissolution. Only one or two of the politicians interviewed had some doubts about the timing of the added expenditure. For the overwhelming majority, any such distant monetary and economic consequences of a creation of money in the midst of full employment seemed completely unworthy of consideration.

On the other hand, the practical impossibility of keeping a government cash-surplus in the face of expenditure-prone politicians was conceded without hesitation. A very impressive slogan "cash tickles desire," circulating during the year before, had done much to impress minds, even if not to alter decisions.

Political thinking, after all, follows quite different channels from economic fiscal-monetary-thinking or thought. It is prone to suggestive catchwords and mental contagion. It appreciates new ideas more than approved methods and emotional more than logical issues. It seems, therefore, of little use to confront our politicians with issues of such complex nature as the fiscal-policy program. Such issues will have to be broken down into simple, elementary truths and impressive formulas of action before poli-

ticians are asked to decide on them. To develop such formulas or, at least, to hit upon plausible slogans will become one of the future tasks of public finance as well as economics. The new branch of fiscal psychology seems fit to help understanding and preparation for such a task.

IV

In the meantime, a number of other jobs waits to be done by fiscal psychologists. In France, where Henry Laufenburger already has included fiscal psychology in his standard textbook on public finance,[11] a new theory of economic thresholds has been developed by Prof. Reynaud of Strasbourg.[12] Founded on fiscal experiences with tax resistance that starts only after a certain threshold of unnoticed taxation has been surpassed, an analogy is drawn even to currency depreciation. Not unlike taxation, creeping inflation remains more or less unnoticed by most people for quite a time—until a certain degree of money depreciation has taken place. Then suddenly a threshold of sensibility will be reached, when all become aware of rising prices everywhere. From here, close connections can be established with the late Albert Aftalion's psychological theory of foreign-exchange rates pointing to some meta-economic factors of price-formation in the foreign-exchange markets. Psychological analysis can help in explaining many phenomena in economics as well as in public finance.

In its own field, fiscal psychology proper will have to analyze further the market conditions for public loans, the financial credit of public authorities, and to develop rules when to turn to loans instead of taxes and vice versa. The new instrument of moral persuasion, once restricted to central-bank policy, has to be at the disposal of fiscal agencies as well. Besides, the whole area of the public relations of government as such, as distinct from the changing actors on the political scene, needs exploration in terms of social and individual psychology.

In order to learn from other peoples' experiences, international comparisons of tax mentality, inflation-sensibility and similar psychic backgrounds of financial activities must be carried out.

[11] H. Lanfenburger, *Traité d'Economie et de Législation Financière*, Paris, 1954. See also H. Lanfenburger, *Théorie économique et psychologique des Finances Publiques*, Paris, 1956.

[12] P. L. Reynaud, "Récessions et seuils économiques," *Revue Economique*, Novembre 1957.

THE FEDERAL FISCAL YEAR: ITS ORIGIN AND PROSPECTS

S. STANLEY KATZ *

TEN of the last eleven federal fiscal years have begun with Congressional action on annual appropriation bills for the federal agencies still to be completed. Essentially, it is claimed, the less-than six months between receipt of the President's budget (in mid-January) and the start of the fiscal year (on July 1) does not provide adequate time for the Congress to consider and act on some $60 or $70 billion worth of annual appropriations.

In all of the ten years, the Congress has adopted so-called " continuing resolutions " authorizing interim expenditures (generally at the prior year's rate) under the as yet unappropriated-for programs, pending enactment of the regular appropriations. Unfortunately, these " stop-gap " substitutes have proved less than satisfactory, and in recent years purportedly more permanent solutions to the timely appropriation problem have been advanced.[1] A common feature of these proposals is the abandonment of the present July 1–June 30 federal fiscal year in favor of a fiscal period corresponding to the calendar year.

A shift in the government's fiscal period appears to be a reasonable approach to providing the Congress with more time for its annual appropriation activities—until it is realized that for half a century the federal fiscal year did in fact begin on January first. In 1842, however, the Congress saw fit to abandon the calendar year and to adopt the present fiscal year, because it had been unable to complete its action on annual appropriations before January first!

Needless to say, the facts of federal fiscal life have changed considerably since then. The consequences of returning to a calendar-fiscal year therefore deserve consideration and, accordingly, are examined in the second section of this paper. It is equally instructive to trace the events and circumstances that led to the initial adoption of the present federal fiscal period. Such a review is presented first, in the following section.

I

The First Congress of the United States convened on March 4, 1789. The new Republic was nominally without funds, however, until the first appropriation act was approved some six months later, on September 29. Pursuant to the Constitution's prescription that " No Money shall be drawn from the Treasury, but in Consequence of Appropriation made by Law . . . " an act was approved on that date " . . . making Appropriations for the Service of the

* The author is an economist with the U. S. Bureau of the Budget. Valuable comments and suggestions on an earlier draft of this paper were made by Samuel M. Cohn, Carl W. Tiller, Robert L. Hubbell and Fritz Morstein-Marx. The views expressed here, however, are the author's, and do not necessarily reflect those of the Bureau of the Budget or the individuals mentioned.

[1] S. 1838, introduced by Senator Warren Magnuson of Washington on April 30, 1959 (86th Cong., 1st Sess.), is a recent example.

present year . . ." [2] (1789). This first appropriation act consisted of only one section, some thirteen lines. It provided ". . . two hundred and sixteen thousand dollars for defraying the expenses of the civil list . . . one hundred and thirty-seven thousand dollars for defraying the expenses of the department of war . . . one hundred and ninety thousand dollars for discharging the warrants issued by the late board of treasury . . . and . . . ninety-six thousand dollars for paying the pensions to invalids." [3] In total, then, the first appropriation provided authority for $639,000 of spending in 1789.

More important than the amount appropriated is the fact that funds were provided " for the Service of the *present year.*" By selecting these precise words, the First Congress implicitly decided that the government's fiscal period was to coincide with the calendar year. This was a reasonable decision. The calendar year was, and still is, the most easily comprehended and most frequently used period for recording the activities of individuals and businesses. Also, there was no necessity for the First Session to appropriate funds beyond the " present year." The next session of the First Congress, presumably still expected to meet on the first Monday of the following December as provided by the Constitution, could appropriate as it saw fit for the year starting January 1, 1790.

Instead of the first Monday in December 1789, the Second Session of the First Congress met on the following January 4. It enacted the appropriation for 1790 on March 26,[4] almost three months after the start of the year. In doing so, the legislature confirmed the practice of voting spending authority for a period of 12 months starting on January 1. A supplemental appropriation for 1790 was enacted by the Second Session on August 12.[5] The Third, and last, Session of the First Congress met on December 6, 1790, and appropriated for spending in 1791 on February 11 of that year.[6]

Subsequent sessions of the early Congresses continued this general pattern—convening early in December or on an agreed-upon, generally earlier, date; enacting the current year's appropriation a month or more after the year had started; and, when necessary, providing supplemental spending authority during the year.

The practice of appropriating funds for a given year well after it had already begun seems to have posed no particular problem in the first years of the Republic. Annual total spending remained relatively small, and the absence of a formal federal spending procedure allowed sufficient flexibility to offset inconveniences accruing from after-the-fact appropriations. Funds were generally voted by the early Congresses in terms of broad expenditure categories, permitting the executive branch considerable latitude in the actual application of funds to alternative purposes. Also, most outlays were made for one-time, nonrecurring purposes during this early period, and these could be articulated with the provision of funds without serious problems. These halcyon days, however, were not to last.

[2] 1 U. S. Statutes 95 (1789).

[3] *Ibid.*

[4] 1 U. S. Statutes 104 (1790).

[5] 1 U. S. Statutes 185 (1790).

[6] 1 U. S. Statutes 190 (1791).

In response to the growing needs and pressures of the time, federal funds came to be used for more numerous and diverse purposes. The level of federal spending quickly reflected this development. Federal outlays rose from a total of $4 million for the 3-year period 1789-1791, to $7½ million in 1795. By 1799, spending had reached $10 million.[7] The content of federal outlays also changed. Programs of a continuing nature, requiring an uninterrupted flow of appropriations and expenditures, became a larger and more important part of total spending. As a consequence, annual requests for appropriations covered larger and larger amounts of funds and became increasingly more detailed and complex.

As would be expected, the shift in the size and scope of government spending ended the period when late (i.e., after January 1) enactment of annual appropriations was a matter of indifference. Obviously, an annual fiscal hiatus of two or three months duration effectively hobbled the operations of year-round programs, and growing numbers of federal government suppliers, employees, and other creditors did not suffer in silence. Unfortunately, however, larger and more complex appropriation requests gave rise mainly to protracted debate, delaying even more the date when appropriation bills were approved each year.

Perhaps the various early congressional sessions would have been able to overcome the size and complexity hurdle had it not been for a further complication in the appropriation process—the date prescribed by the Constitution for the first meeting of the Congress each year. Article I states that the Congress shall meet each year on " the first Monday in December, unless they shall by Law appoint a different Day." Unless a very much earlier date were selected in advance—and there were serious obstacles to doing so—the convening sessions had only three or four weeks in which to introduce, review, debate, and enact the appropriations for the coming year before it was already upon them.

The early Congresses attempted to escape the twin-horned appropriation dilemma by streamlining the procedure followed in enacting annual appropriation measures. Some modifications in congressional procedure, introduced ostensibly for other purposes, also had an important bearing on the appropriation process.

The desirability of a locus of responsibility and expertise in handling appropriation matters, for example, was abundantly clear to the legislators from the start. During the First Session of the First Congress, each House appointed a special committee to handle appropriation and other financial measures.[8] These committees were continued from year to year by subsequent sessions of the early Congresses. The House Committee on Ways and Means, originally charged with appropriation as well as revenue matters, was finally made a standing committee in 1804;[9] similar action followed on the Senate side.

Frequently, an earlier date for the first meeting of the congressional session was adopted, thus permitting the legislators additional time in which to

[7] Secretary of the Treasury, *Annual Report on the State of the Federal Finances for the Fiscal Year Ended June 30, 1957* (Washington: Government Printing Office, 1958), p. 335.

[8] See *Annals of the Congress of the United States, First Congress 1789-1791* (Washington: Gales and Seaton, 1834), I, 92.

[9] Lewis Deschler, *Constitution, Jefferson's Manual, and Rules of the House of Representatives of the United States Eighty-Fifth Congress* (Washington: Government Printing Office, 1957), p. 356.

consider and act upon annual appropriations and other measures before the year in question started. But earlier meetings entailed inconvenience if not sacrifice for the Members of Congress, and proposals for advancing the convening date were presumably greeted with something less than enthusiasm. Nevertheless, alternate dates often anticipated the one specified in the Constitution by a month or more.

The annual meeting date was first advanced in 1791. In that year, the First Session of the Second Congress met on October 24, and by December 23 had completed action on the appropriation bill for 1792.[10] Between 1789 and mid-1820, some 18 acts were passed providing for the first meeting of the Congress on days other than the first Monday in December. Most of these alternative dates were in October or November.[11]

Splitting the annnal appropriation bill into two separate measures—one for general (i.e., civil) and one for military purposes—was also directed toward a more expeditious enactment of annual appropriations. This procedure was first adopted in 1794. A general support of (civil) government appropriation was approved on March 14 of that year (3rd Congress, 1st Session),[12] followed a week later by an appropriation for the military establishment.[13]

When, as in war periods, there was urgent need for providing funds without the usual delays, the Congress would enact a " partial appropriation bill " shortly after it met. In this way funds were provided to keep otherwise expiring programs alive while the fine points and amounts of the pending appropriation measure(s) were debated at greater length. Once decided, the balances needed would be voted later on in the session.

The first partial appropriation, as such, was enacted in 1796 by the Fourth Congress (1st Session). On March 12 of that year, it enacted a " partial appropriation " of $500,000 for the military establishment.[14] Three months later, on June 1, the balance ($1,318,873) was approved.[15] At first, the partial appropriation was viewed as an emergency measure. Only five such bills were enacted in the 20 years following its first use: in 1798, 1803, 1804, 1813, and 1814.[16] In the next decades, however, enactment of a partial measure became an almost annual occurrence—a development which undoubtedly contributed to the further delay in the enactment of annual general appropriations.

The partial appropriation was not an unmixed evil, particularly from the viewpoint of the Members of the Congress. Before the introduction of this device, funds for the House and Senate had been included in the annual general appropriation bill. When the latter was delayed, so were the former. A partial appropriation, however, provided the vehicle by which the Congress could provide funds for itself without delay. At first, funds for the Senate and House were occasionally added to an urgently

10 1 U. S. Statutes 226 (1791).

11 U. S. Congress, Joint Committee on Printing, *Congressional Directory, 85th Congress, 1st Session* (Washington: Government Printing Office, 1957), pp. 309-310.

12 1 U. S. Statutes 342 (1794).

13 1 U. S. Statutes 346 (1794). A separate appropriation was also generally enacted for the Navy after the Department of the Navy was established in 1798.

14 1 U. S. Statutes 450 (1796).

15 1 U. S. Statutes 493 (1796).

16 1 U. S. Statutes 536 (1798); 2 U. S. Statutes 199 (1803); 2 U. S. Statutes 307 (1804); 2 U. S. Statutes 791 (1813); 3 U. S. Statutes 93 (1814).

needed partial appropriation for, say, the military service. This worked so well that after a time it did not matter whether or not a partial appropriation was otherwise needed. One was enacted anyway—for the Congress alone, if necessary. The war-time partial bill approved on January 20, 1813, for example, provided $1 million for the military service and $1 million for the Navy. To these amounts were added $50,000 for Members of the Senate and House, their officers and attendants, and a further $10,000 for the contingent expenses of the House.[17] The partial bill for 1823, approved on January 14, unblinkingly provided only for compensation of the Senate and House members.[18]

For a time, the various techniques adopted by the Congress did help to mitigate the worst results of the existing appropriation procedure. They had little impact, however, on the bases of the problem: the growing size, scope, and complexity of annual appropriation measures; the increasing importance of providing timely and uninterrupted funds; and the inability of Congress to do so between the date of convening and the start of the calendar-fiscal year.

Meanwhile, federal expenditures continued their step-like climb. From a level of $11 million in 1800, spending rose to a wartime peak of $35 million in 1814, dropping back only to $18 million in 1820.[19] Enactment of the annual general appropriation bill continued to lag behind the start of the year to which it applied, usually by several months. The general appropriation bill for 1800 was approved on May 7; for 1814 on March 24; for 1820 on April 11; and for 1822 on April 30.[20]

Conducting the day-to-day business of the federal government under the conditions outlined above was ultimately the lot of the executive branch department heads. With enviable flexibility, they developed means of continuing their agencies' operations in spite of annual periods of externally imposed illiquidity. In some cases agency expenditures anticipated the enactment of legal spending authority—the Congress having little choice but to provide for such " arrearages " in a subsequently-enacted appropriation bill. In others, expenditures were made (frequently from agency deposits in commercial banks) for one purpose and year from funds appropriated for another purpose and earlier year. Reimbursements would be made between accounts when the general appropriation bill was enacted. Salary disbursements to government employees were frequently postponed and settlements of other obligations were deferred until the agencies' coffers were replenished by the Congress. These various accommodations were cumbersome and unsatisfactory at best, and

17 2 U. S. Statutes 791 (1813).

18 3 U. S. Statutes 721 (1823).

19 Secretary of the Treasury, *op. cit.*, p. 335.

20 2 U. S. Statutes 62 (1800); 2 U. S. Statutes 106 (1814); 2 U. S. Statutes 555 (1820); 2 U. S. Statutes 668 (1822). Odd-year appropriations (i.e., those providing for spending in years ending in an odd digit) were generally enacted earlier in the year than were their even-year counterparts. The reason is this: Sessions of Congress which met in years in which biennial November elections were held, adjourned by the following March 4 when the newly-elected legislators took office. (Because the First Congress met on March 4, 1789, pursuant to an act of the Continental Congress, the term of congressional office began—until 1934—on that date.) The sessions meeting in non-election years, on the other hand, did not generally adjourn until June or July. Election-year sessions were therefore some 4 or 5 months shorter than the others, and the Members of Congress were enjoined to earlier action on the (odd year's) appropriation bills.

again did not come to grips with the basic timing problem.

Executive branch dissatisfaction with the chronically late provision of funds finally became vocal in the 1820's. Secretary of the Navy, Samuel L. Southard, brought it into the open in his 1825 report on the Navy's finances. He wrote (to the 19th Congress):

> One of the most serious inconveniences under which the Department labors in the administration of the concerns of the navy, is the *time* at which the appropriation bills are passed by Congress. They are passed, in the short session, late in February, and, in the long session, generally in May, so that, during a period of from one-fourth to a third of the year, the Department is left [only] with funds previously appropriated, and must, of necessity, permit expenditures not yet legally authorized.[21]

In the same report, Southard pointed out a further problem posed by the late enactment of appropriations:

> It is the will of Congress often to change the wording and character of the appropriation, and, after the bill is passed, it is a month or six weeks before the instructions under the new appropriation can be given to and acted upon by the agents. It consequently follows, that, for nearly one-half of the year, the Department acts in perfect ignorance of the law under which it is bound to act. Expenditures are made, under one form, when they ought to have been made under another. The law is, necessarily, not complied with, because it is passed after the act is performed.[22]

An earlier passage of the appropriation bill would remedy the problems faced by his department, Southard advised the Congress.[23] But an alternative proposal he advanced at the same time proved more instructive. He reasoned, perhaps, that if the Congress could not accommodate itself to the existing federal fiscal year, the fiscal year might be tailored to the Congress. At any rate, in his 1825 report, Southard recommended that the federal government's fiscal year be shifted forward three months and end on April 1.[24] This is perhaps the earliest public recommendation for abandoning the calendar year as the government's fiscal period.

The Congress chose not to avail itself of Southard's advice. The general appropriation for (calendar year) 1826 became law on March 14;[25] for 1827, on March 2.[26] Presumably not easily discouraged, Southard again proposed a change in the fiscal year in his report to the Congress in 1827:

> The estimates and appropriations are made for the year commencing and ending on the first January. The appropriation laws are never passed until after that period. The Department is, therefore, left, sometimes for six weeks or two months, without funds for the use of the navy . . . . The consequences are too palpable to require comment. The remedy is simple: to make the appropriations, in the first instance, for a year and a quarter, and let those for subsequent years commence on the 1st April.[27]

The Congress continued to seek a solution to the appropriation problem in its own way, mainly by variations of existing procedure. One such experi-

[21] *Control of Federal Expenditures, A Documentary History, 1775-1894,* compiled by Fred W. Powell (Washington: The Brookings Institution, 1939), p. 432.

[22] *Ibid.*

[23] *Ibid.*, p. 433.

[24] *Ibid.*

[25] 4 U. S. Statutes 142 (1826).

[26] 4 U. S. Statutes 208 (1827).

[27] *Control of Federal Expenditures, op. cit.*, p. 434.

ment was tried in 1828. In addition to the appropriation measures for that year, the 20th Congress enacted four bills providing funds for the first three months of 1829. These were for United States fortifications, support of the Navy, payments to revolutionary and other pensioners, and the military service.[28]

This departure was greeted with restrained enthusiasm by the executive departments. Navy Commissioner, John Rodgers, for example, wrote in 1829, to Navy Secretary, John Branch, that ". . . until the Congress adopted the practice of appropriating for the first quarter of a succeeding year, it was frequently unavoidable to authorize the application of moneys, *for the time,* to other than their legitimate objects . . . . But now, and so long as Congress shall adhere to the practice of appropriating in anticipation for the first quarter of the succeeding year, the necessity of taking moneys from one appropriation and applying them to another no longer exists, and need never be resorted to except in cases of emergency." [29] In spite of its favorable reception, it appears that the advance appropriation procedure was not used again.[30]

The timely appropriation issue was revived again in 1834, this time by Secretary of the Treasury, Levi Woodbury. In his *Report on Finances* for that year, Woodbury supported the previously-advanced proposal for starting the fiscal year on April 1. His motives, however, differed from Southard's and the other department heads'.

In order to report early each session on the state of federal finances, as required by law, the Treasury Department found it necessary to close the government's accounts on September 30 each year and estimate the fiscal results for the October-December quarter. Advancing the fiscal year by one quarter would perhaps have eliminated the need for the last quarter's estimates. With this goal presumably in mind, Woodbury wrote the Congress in 1834:

> If the year was (sic) to commence after the last day of March . . . and the annual appropriations began from that date, many delays and embarrassments could be avoided; and the information on the condition of the receipts and expenditures of the previous year to be laid before Congress, each session, would be much more full and accurate.[31]

Woodbury continued to advocate a change in the fiscal year period in his annual *Report* for 1835, 1836, 1838, and 1839.[32] The Congress, for its part, continued to defer formal consideration of this executive branch proposal. But the seriousness of the appropriation problem was by this time acknowledged, and pressures for its permanent solution were mounting in the Congress as well as in the executive departments.

The issue seems to have come to a head in the Congress on December 16, 1841, shortly after the Second Session of the 27th Congress convened. In connection with the partial appropriation bill for 1842 up for consideration by the Senate that day, Senator William R. King of Alabama took his fellow

[28] Daniel T. Selko, *The Federal Financial System* (Washington: Brookings Institution, 1940), p. 402.

[29] *Control of Federal Expenditures, op. cit.*, p. 474.

[30] Selko, *op. cit.*, p. 420.

[31] Levi Woodbury, "Report on Finances, December 1834," cited in *Report of the Secretary of the Treasury of the United States, 1829-1836* (Washington: John C. Rives, 1851), III, 497.

[32] *Report of the Secretary of the Treasury, op. cit.*, III (1829-1836), 652, 701; IV (1837-1844), 349-350.

Senators to task for consistently sidestepping the appropriation issue. He deplored the fact that:

> Congress [has] for years been too much in the habit of making partial appropriations in the beginning of each session for nothing more than the payment of the members themselves. In the meantime business goes on, and for months many of the officers of the Government . . . are thrown into the hands of brokers and shavers, to raise, at exorbitant interest, the necessary means for the support of their families, while waiting for the general appropriation bills of Congress, which might not come up till February next.[33]

At Senator King's insistence, the partial appropriation measure for 1842 was recommitted to the Senate Committee on Finance with instructions that it be redrafted into a general appropriation bill. The following Monday, December 20, 1841, the draft bill was returned to the Senate floor by Chairman of the Finance Committee, George Evans of Maine. It had not been revised. Senator Evans proceeded to describe at some length the reasons why his Committee could not redraft the partial bill into a general appropriation measure—including the fact that it had originated in the House of Representatives.[34] The Senator from Maine then went the April 1 fiscal period proposal of the executive branch one better, concluding his remarks with: "if Congress would commence the work of making appropriations in advance, and make the first or second week of the [fiscal] year commence on the first of July, a great saving and convenience, and a shortening of the sessions of the Congress would, perhaps, be the result." [35]

From the events that followed, it may be surmised that during the next months Senator Evans marshalled the support of his colleagues for his fiscal year proposal. On June 23, 1842, some six months after his statement in the Senate advocating a fiscal year change, Senator Evans introduced a bill to carry out his proposal. The Evans bill, "To define and establish the fiscal year of the Treasury of the United States," provided for a federal fiscal year starting on July 1 and ending on June 30.[36] The transition was to be accomplished by a six-month fiscal year 1843 (from January 1 through June 30). As a result of this arrangement, succeeding fiscal years were to be designated by the year in which they ended.

In support of his fiscal year bill, Senator Evans pointed out that the Senator from New Hampshire, Levi Woodbury, had advocated a change in the fiscal year some years before, as Secretary of the Treasury. But even this modicum of support seems to have been unnecessary. The Senate promptly determined that in view of the desirability of and support for the measure, there was no need to refer it to Evans' Committee on Finance.[37] The bill was read twice, and then resolving itself into a "Committee of the Whole," the Senate proceeded to consider it. No amendments were proposed, no dissent was voiced, and the bill was reported and ordered "engrossed" for a third reading. The Senate approved the Evans bill the next day, June 24, 1842.[38]

33 *Congressional Globe*, eds. Blair and Rives (Washington: 1841), XI, part 1, pp. 21, 22.

34 *Ibid.*, p. 32. The general appropriation bill for 1842 reached the Senate on May 2, 1842.

35 *Ibid.*

36 *Ibid.*, p. 668.

37 *Ibid.*

38 *Ibid.*, p. 675.

Early the following month, on July 7, 1842, the fiscal year bill as approved by the Senate was introduced in the House of Representatives where it was referred to the House Committee of (sic) Ways and Means.[39] The bill was duly reported by the Ways and Means Committee, and on August 18, 1842, it was approved without debate by the full House.[40]

All that then remained was Presidential approval. As expected, President John Tyler signed the act "To define and establish the fiscal year of the Treasury of the United States," on August 26, 1842.[41] With this, the adoption of the federal fiscal year as it exists today was completed.

II

The fiscal period established in 1842 met—until fairly recently—the timing problems previously encountered by the Congress in its consideration of annual appropriation measures. No serious dislocations in government programs seem to have resulted from its adoption, and, judging by its continued existence, the July 1–June 30 year has proved to be a generally satisfactory period for planning, conducting, and accounting for federal activities involving the expenditure of funds.

Two major factors underlay the relatively smooth transition from a calendar to a fiscal year period. First, although the federal government had expanded considerably between 1789 and 1842, it was still comparatively small in both size and scope at the time the fiscal year shift was undertaken. In 1844, the first full year on the new fiscal basis, federal spending totaled only some $22 million.[42] Secondly, most of the important changes in federal fiscal institutions, procedures, and the like, were a consequence of the expansion of governmental activities (and spending) during and after the Civil War. These changes were tailored to the government's existing financial structure, a main pillar of which was the July 1–June 30 fiscal year.

The factors which helped facilitate adaptation to the revised financial period in 1842 have long since vanished from the fiscal scene. In the interim, a broad expansion of federal government responsibilities and a concomitant elaboration of the financial structure has occurred. A change now in so basic an institution as the fiscal year would do much more than provide the additional time for appropriation action desired by proponents of such proposals. The effects of such a move would permeate all levels of a vast and extremely complex federal structure, and many additional consequences could reasonably be expected. To the extent that these can now be foreseen, they warrant careful examination in considering a possible revision in the fiscal period.

An exhaustive review of the complications that could arise from a decision to revise the fiscal year is not the intent of this paper. The complexity of government operations, the number of possible variations of fiscal year proposals, and the fallibility of human foresight

[39] *Ibid.*, p. 732.

[40] *Ibid.*, p. 909. Albert S. Bolles, *The Financial History of the United States from 1789-1860* (2nd edition, New York: Appleton & Co., 1885), I, 575, notes that the need for making the change in the fiscal year was so obvious that "no report was made on the subject by any committee nor was there any opposition to the change. The delay, therefore, in changing the date is the more unaccountable."

[41] 5 U. S. Statutes 536 (1842).

[42] Secretary of the Treasury, *op. cit.*, p. 335.

would make such a catalog a vast undertaking. Major problems would, of course, arise in connection with present budget formulation, submission and authorization procedures. Some of these problems are reviewed below, in terms of a six month advance in the fiscal year starting date. This is the most simplified case, however, and the relevance of the conclusions drawn will depend on the particulars of the fiscal year proposal in question.

The timetable for the present budget cycle is determined for the most part by the Budget and Accounting Act of 1921 (31 U.S.C. 1). The Act requires, in part, that " The President shall transmit to the Congress during the first fifteen days of each regular session, the Budget, which shall set forth his Budget message, summary data and text, and supporting detail." The terseness of this sentence belies the complexity of the budget cycle it engenders. The preparation phase of the budget cycle may in fact begin some fourteen months before the start of the fiscal year under consideration. For most agencies it follows these general but highly over-simplified lines.[43]

In the spring of each year, the operating units of the various agencies begin to develop information on anticipated workloads and activity levels for the budget year to start more than 12 months later. Meanwhile, economic, international, and other assumptions and forecasts which will underlie the budget for the fiscal year in question are developed jointly by the Bureau of the Budget, the Treasury, the Council of Economic Advisors, and other agencies concerned.

During April or early in May the general budgetary outlook is discussed by the President and the Cabinet. The major agencies then submit to the Bureau of the Budget the results of their preliminary thinking on their over-all financial requirements for the budget year. These broad figures are combined with an estimate of the needs of the smaller agencies, and the resulting total is compared with a preliminary estimate of anticipated revenues. This first full picture of the budget situation is the basis of further discussion with the heads of the major departments and agencies to provide guidelines for developing agency estimates within the framework of the total budget situation.

Preliminary agency budget estimates, consistent with the guidelines provided but still tentative, are submitted to the Bureau of the Budget in May and June. They are carefully reviewed and analyzed by examiners familiar with the specific programs and become the basis for discussion between each agency head and the Director of the Bureau of the Budget. After these discussions, the Director, in the light of the then current budget outlook, recommends to the President tentative planning figures for each major agency. The effects of the President's decisions on agency programs may then be discussed again by the agency heads and the Director. Meanwhile, revenue prospects are again reviewed and the tentative budget plan may be examined again by the Cabinet.

[43] See U. S. Bureau of the Budget, "Preparation and Execution of the Federal Budget" (Washington: Bureau of the Budget, May 1958, mimeographed), and Jesse Burkhead, *Government Budgeting* (New York: John Wiley and Sons, Inc., 1956), pp. 88-107, for a more detailed description of the federal budget cycle. Burkhead's division of the budget cycle into four main phases (preparation and submission, authorization, execution, and audit) is the framework used for much of the subsequent discussion in the present paper.

During the next three months, July through September, the agencies compile the detailed schedules and supporting materials prescribed by the Bureau of the Budget for submission to it by September. Hearings are held with agency representatives during this period at which all relevant aspects and details of the agency submissions are considered.

When the hearings are completed, the examiners' recommendations are prepared for the "Director's review." The review, which runs through early December, focuses primarily on still pending policy issues. Recommendations which emerge from this review are transmitted by the Director of the Bureau of the Budget to the President for his decision. As these issues are resolved, each agency is notified by letter of the amounts it has been allowed. The agency estimates and supporting materials are then revised to conform with its budget allowance for inclusion in the budget document. The completed detailed schedules for each agency are combined to arrive at the budget totals and provide the basis for the various summary statements and special analyses in the budget document. The preparation and submission phase of the budget cycle is largely completed with the transmittal of the budget document to the Congress in mid-January, although staff of the House Appropriations Committee usually start work somewhat earlier using final page proofs.

Authorization, the next phase of the budget cycle, gets underway formally with hearings by the House Appropriations Committee on the agency appropriation requests. As the timetable outlined above indicates, the hearings are held during the slack season for agency budget preparation activities, and agency heads and budget officers are called upon to present oral and written justification for their agency's requests for funds. Hearings before the House and Senate Appropriation Committees continue during the next several months. After each appropriation bill is finally acted upon by the full House and Senate, it is sent to the President for signature or veto. A "continuing resolution" takes care of appropriations still pending at midnight on June 30.[44]

Shifting the fiscal year to a January 1–December 31 basis would render significant changes in the pattern of budget preparation, submission and authorization outlined above. Looking first at the authorization phase of the cycle, six additional months (i.e., July through December) could, theoretically, be added to the time available for annual congressional review and authorization of appropriations, assuming that the submission of the President's budget would continue to be required early in January. This additional time would presumably eliminate the need for adopting "continuing resolutions." However, what at first appears to be a six-month addition to the annual authorization

[44] House Joint Resolution 439, enacted on June 30, 1959, provided temporary appropriations "for continuing projects or activities . . . for which appropriations, funds, or other authority would be available in the following appropriation Acts for the fiscal year 1960: Legislative Branch Appropriation Act; General Government Matters Appropriation Act; Independent Offices Appropriation Act; Department of Agriculture and Farm Credit Administration Appropriation Act; Department of Defense Appropriation Act; Department of Commerce and Related Agencies Appropriation Act; Departments of Labor, and Health, Education, and Welfare Appropriation Act; Departments of State and Justice, the Judiciary, and Related Agencies Appropriation Act; District of Columbia Appropriation Act; and the Public Works Appropriation Act." U. S. Congress, *Congressional Record* (Washington: Government Printing Office, June 30, 1959), p. 11205.

period shrinks by the number of months prior to December 31 that the Congress adjourns each year. Adjournment in August or September would mean only an additional two or three months for congressional action on appropriations.

Regardless of the number of months that might be added, the chances are that appropriation action would tend to be concentrated toward the end of the period of time available for it, as is presently the case. Provision of funds could then continue to take account of any last minute changes in agency needs, in technology, and the like, that might occur. Under these circumstances, it is possible that some appropriations would still be pending late in the year or near the end of the congressional session that might spill over into the next fiscal year. In that event, there would be a continuing need for continuing resolutions. This possibility is reinforced by the fact that with additional time available, the Committees might wish to go into agency budget requests in greater detail. This, of course, would not only help negate any gains in time but, worse, could divert legislative focus from major issues of policy to minor questions such as numbers of typewriters.

Lengthening the authorization period also lengthens the period during which agency representatives would probably be expected to appear before the Appropriation Committees, with a concomitant increase in the volume of supporting materials that would have to be supplied. This would increase the burden on the agency head and his budget personnel at a time when they were already becoming involved in preliminary preparation of the agency's budget for the next year. Moreover, it would erode further the already limited time that agency heads now have for what is, after all, their principal responsibility—running their departments.

There is the parallel danger that extension of the authorization period through, say, August, might immerse the legislative branch in the preparation phase of the budget cycle, the exclusive domain of the executive branch at present. With appropriation hearings scheduled during July or August, the same months that the formulation of executive agency budgets for the following fiscal year is underway, it is most probable that agency planning figures and related data would find their way to the congressional Appropriation Committees —by request, or at the initiative of a disappointed budgeteer. Advance Committee reactions to executive branch decisions on budget issues could seriously disrupt the present budget preparation process and might even raise constitutional questions concerning executive-legislative separation of powers.

There is perhaps a more compelling reason for resisting a fiscal year change that would mean a lengthening of the budget cycle. The federal budget is, among other things, the fiscal plan of the government for a specific period in the future. Accordingly, the annual budget totals include estimates of revenues and expenditures under legislation recommended by the executive branch as well as under existing laws. As a plan, the budget is necessarily based in part on forecasts and projections—of national economic activity, prices, international developments, program levels, and the like. On this score it comes in for frequent criticism, mainly because of the length of the present budget cycle. It is argued that projections of events that are dependent on prior con-

gressional action or that lie a year or more in the future can hardly be expected to come very close to the mark. Burkhead points out, for example, that " [the present] elongated time span . . . makes program planning less realistic in those cases where little operating experience in the current fiscal year is known before budgets must be prepared for the forthcoming year. Budget planning must start even before the action of the Congress on the current budget has been completed." [45] Criticism of this aspect of the budget as a plan is not without considerable justification. However, in defense of the budget, it should be pointed out that the estimates for each agency finally printed in the budget document rest on fairly firm footing and reflect late revisions in budget plans necessitated by changed conditions.

Budget planning has not proceeded beyond its preliminary stages when detailed agency and total government " actual " receipts and expenditures for the fiscal year just ended are reported by the Treasury Department. These data are available about three weeks after the close of the fiscal year they cover and provide an important benchmark for subsequent budget planning at all levels.[46]

Similarly, the final regular appropriations for the current fiscal year are usually enacted some time before the detailed agency budget submissions are due in the Bureau of the Budget. Revisions in agency plans to take account of congressional action on current year appropriations can be made with little difficulty during this stage of budget preparation. Subsequent changes in agency budgets necessitated by actual program developments in the current year or by other changed circumstances can be introduced later in the process, and limited changes in the budget can be made almost until the document is locked up for printing. Finally, even the amounts printed in the document are by no means sacrosanct. Budget inflexibility is therefore not as great at present as it is frequently purported to be.[47]

The degree of flexibility presently found in the budget would be significantly reduced and the budget's planning function seriously impaired, however, by an elongation of the present budget cycle.

In order to provide six additional months for congressional authorization action, the executive budget would have to be sent to the Congress almost a full year before the start of the calendar-fiscal period to which it applied. This compares with almost six months under present procedures.

The preparation and submission phase of the budget cycle would begin and end under this arrangement before the actual financial results for the year just ending were available to the agencies. Thus a very important and useful budgeting benchmark would be erased. Budget planners would have to rely instead on actual data for the calendar

[45] Burkhead, *op. cit.*, pp. 269-270.

[46] The " Monthly Statement of Receipts and Expenditures of the United States Government for the Period from July 1, 1958 through June 30, 1959 " was released on July 20, 1959. Although these data are preliminary, in most cases they do not differ much from the " final " figures available a few months later.

[47] Along these lines, Burkhead states that " It should not, however, be concluded that the long time period required for budgetary planning and congressional review makes for complete rigidity and unresponsiveness . . . . When the exigencies of the situation demand it, some flexibility can be found; it is not inherent." (Burkhead, *op. cit.*, p. 104.)

period that ended two years before the start of the budget year in question and on available monthly financial data for part of the then-current year.

Moreover, appropriations for the calendar-fiscal year preceding the budget year would be still pending for most of the agency budget formulation period. In addition, the agencies would have no operating experience in the year before the budget year (and less than a year of operating experience in the year before that) from which to draw budget planning guidance.

A fiscal year shift that lengthened the budget cycle would therefore deprive agency heads and budget officials of three major building blocks of budget planning—actual data for the past year, appropriations for the current year, and operating experience in the current year. The upshot could perhaps be almost meaningless preliminary budget planning by the agencies followed by hasty and poorly conceived budget decisions based on inadequate information. The quality of agency budget planning and the planning function of the federal budget would suffer accordingly.

It is one thing to misjudge (and subsequently adjust) the level of expenditures required to carry out specific programs. It is quite another to formulate budgets and fiscal policy on assumed levels of economic activity that later prove to be wide of the mark primarily because of long forecasting lead-times. Such errors can mean the difference between a stabilizing federal budget and one that is cyclically-reinforcing.

With the present, somewhat less than perfect state of forecasting technology, most forecasts of budgetary parameters take off from the latest actual data that are available. The reliability of these forecasts depends to an important degree, therefore, on the proximity of the time that they are made to the period they cover. The narrower the time gap, the more current the developments that can become elements of the forecasts, and, hopefully, the more appropriate the fiscal policy prescriptions the budget will reflect.

Under present arrangements, the budget for any given fiscal year is based on—and in turn implements—fiscal policy decisions that were largely formulated from six months to a year before the start of the fiscal year to which the budget relates. Major shifts in the economy during that period and during the fiscal year in question can render the fiscal plan obsolete and even damaging. A budget that was designed to meet a continued recessionary period of under employed resources that met instead a vigorous economic revival and expansion would be a case in point.

A six month addition to the gap between policy formulation and implementation (e.g., by lengthening the appropriation period by six months) would clearly increase the danger of faulty budgetary forecasts and assumptions and of inappropriate fiscal policy prescriptions in the budget. Rather than lengthening the budget cycle, most experts in the field of government budgeting agree that the present budget cycle is already too long for realizing the budget's potential contribution to economic stability. For example, Burkhead states: "If the budget is to be modified in accordance with the requirements of economic stabilization, such modification cannot be undertaken a year or more in advance. Economic forecasts are not this reliable. Budgetary changes which are to produce modi-

fications in the level of national income and employment may need to be planned and proposed within the space of a few months." [48]

In spite of pressures for moving in the opposite direction, proposals for shortening the length of the present budget cycle merit serious consideration.[49] Most of the proposals would reduce the budget preparation phase of budgeting by permitting budget planning to proceed along broader program lines than is presently possible. The net result would be a substantial reduction in the amount of detailed supporting materials needed, and a considerable saving of time. In support of his recommended revisions, Smithies points out that " budgets . . . are prepared in a degree of detail that is quite unwarranted by the uncertain assumptions on which the estimates are based. A major source of government waste could be eliminated if estimates were prepared in no greater detail than was justified by their accuracy." [50] However, " the possibilities for shortening the time span rest . . . on a fundamental point—the willingness of Congress to enact appropriations which are supported only by a general presentation of program outlines. Unless the Congress is willing to abandon the detail, it will be difficult to compress the period of budget preparation and review." [51]

There is a further observation, only indirectly related to the budgetary cycle, that deserves mention here. Under present procedures, an outgoing Congress determines, ahead of the biennial November elections, the major outlines of the government's programs and policy for the first six months of the next congressional term and calendar year. For example, the Second Session of the 85th Congress which convened on January 7, 1958, and adjourned on August 24, 1958, enacted appropriation and other legislation that provided program guidelines and/or funds for six months of the following calendar year. Consequently, the First Session of the 86th Congress had little effect, fiscally, until July 1, 1959, some six months after it convened. A January 1 starting date for the fiscal year would extend this six month period to one year. Had the past fiscal year (1959) corresponded with calendar year 1959, for example, the Second Session of the 85th Congress would have determined the outlines of federal activities for the entire calendar year (1959) that followed its adjournment.

Under such quasi "lame duck " conditions, an incoming session of the Congress would find that a large portion of its normal functions had been exercised by its predecessor, possibly in a way not entirely to its liking. Its fiscal influence on government activities during its term in office would accordingly be reduced, while it, in turn, would determine the fiscal outlines for the next year's federal activities. An even more anomalous situation would arise in the executive branch. A newly elected President would be able to exert only limited fiscal influence until two years after he took office. A President who took office in January of 1965, for example, would find (a) appropriations already enacted

[48] *Ibid.*

[49] See, for example, the proposals for shortening the budget cycle (and other budgetary reforms) advanced by Arthur Smithies, *The Budgetary Process in the United States* (New York: McGraw-Hill Book Co., Inc., 1955), pp. 178-192 and 218; and by Frederick Mosher, *Program Budgeting* (Chicago: Public Administration Service, 1954), pp. 237-244.

[50] Smithies, *ibid.*, p. 44.

[51] Burkhead, *op. cit.*, p. 271.

for his entire first year in office and (b) appropriation requests for 1966 on their way to the Congress in a budget prepared by his predecessor. The " new " President's first budget would cover calendar 1967, two years after he assumed the Presidency.

These, then, are some of the consequences to be considered in contemplating a January 1 starting date for the federal fiscal year. Some of the issues posed above can be, and have been, resolved by other elements of fiscal year proposals that have been advanced. A bill introduced by Senator Magnuson on April 30, 1959 (S. 1838), " To provide for a separate session of Congress each year for the consideration of appropriation bills, to establish the calendar year as the fiscal year of the Government, and for other purposes," would require transmission of the budget by July 15 each year. While shifting the federal fiscal period to a calendar year base, it would not lengthen the span of the budget cycle, and meets some of the objections raised on this score above.

Unfortunately, however, other provisions of fiscal year proposals may introduce further complications of their own. S. 1838, for example, provides for a special " fiscal session " of the Congress during November and December of each year, limited mainly to considering appropriations for the following calendar-fiscal year. In doing so, the bill would restore executive and legislative " lame duck " procedures similar to those that were eliminated in 1933 by the Twentieth Amendment.[52] Moreover, it would separate by six months the President's statements of government policy in his *Economic Report* and *Message on the State of the Union* from his budget which would implement them.

III

To summarize the foregoing, two factors were chiefly responsible for the government's abandoning the calendar-fiscal year and adopting a July 1–June 30 fiscal year in 1842. First, under existing laws and procedures the early Congresses had insufficient time in which to enact increasingly larger and more complex annual appropriations. Second, the subsequently adopted practice of annually enacting partial appropriations, mainly for the Congress, proved to be a source of considerable hardship and inequity. The adoption of a federal fiscal year commencing on July 1, was intended to remedy this situation by providing additional time for congressional appropriation action before the start of the government's fiscal period. Adaptation to the new fiscal period was smooth since the government was still relatively small and its fiscal institutions were largely undeveloped. The attendant lengthening of the existing, rather short budget cycle, if recognized, was probably not considered worthy of concern or comment.

[52] Until 1933 the Congress met on the first Monday in December (unless it selected an alternate date) while legislators took office on the following March 4. As a result, incumbents who were defeated at the polls in a biennial November election took part in the session of Congress that convened the next month and legislated as " lame ducks " until the session adjourned on March 3, the day before the newly elected legislators took office. The latter did not meet in a regular session of the Congress, however, until the following December. Similarly, outgoing Presidents served as " lame ducks " from November until March 4, when the incoming President was inaugurated. The Twentieth Amendment was adopted to remedy this procedure. It provided that the Congress shall assemble each year on January 3 (unless a different date is selected by law), and that the legislators' term of office shall begin on the same date. Under the Amendment, the President and Vice President take office at noon on January 20.

Today the Congress is again faced with the problem of its inability to enact all of the necessary annual appropriations in time for the July 1 start of the fiscal year. Resort to "continuing resolutions" has been necessary as a consequence. As a remedy, it is now being proposed that the fiscal year starting date be shifted forward by an additional six months, to start once again on January first. In this way several more months could be provided for appropriation action. Such a change would probably, but not necessarily, permit the enactment of annual appropriations by the start of the new fiscal year. With the vastness and complexity of the present federal fiscal structure, a fiscal period shift would do a great deal more.

A "simple" shift in the fiscal year would pose major problems in connection with the preparation, submission, and authorization phases of the existing budget cycle. First, a January 1–December 31 fiscal year would increase the already considerable burden on the time and efforts of executive agency heads and budget offices. They would be expected to work up and present a greater volume of budget justification material during a longer period of time while at the same time formulating their agency budgets for the succeeding year. Second, more time for authorization would no doubt lead to committee requests for more detail on agency budgets. This might divert legislative attention from substantive policy issues to administrative issues. Third, appropriation hearings in the Congress that overlapped preparation of the next budget by the executive branch could disturb the necessary separation of budget preparation from budget authorization and could diffuse responsibility for budget formulation, now clearly lodged with the President. Fourth, the realism and reliability of program planning and fiscal policy prescription in the budget would be reduced by the proposed change in the fiscal year. Since the budget would be less grounded in actual recent experience than at present, the program planning function of the budget could be seriously undermined. Lengthening the gap between budget formulation and implementation by six months would also render the forecasts and assumptions underlying the budget, and the fiscal policies they dictate, much more tenuous. Fifth, advancing the fiscal year to a calendar year basis would mean that a given session of the Congress would exert even less fiscal influence during its term of office than is now possible. It, in turn, would tie the hands of the next congressional session by enacting appropriations that would govern federal fiscal activities during the following calendar year. A similar but magnified problem would be posed for the executive branch which would be able to put its financial plans fully into effect only after a two-year lag.

The above, then, are some of the potential consequences of a "simple" six-month shift in the fiscal year. Some of them are taken into account by additional provisions of the more sophisticated fiscal year proposals, but not without the possible introduction of still other complications. If a change in that pillar of the federal fiscal institution, the fiscal year, is to receive serious consideration, the costs of all these potential dislocations have to be carefully weighed against the benefits of providing more time for authorizing action by the Congress. On balance, it would appear that the prospects for a continued July 1–June 30 federal fiscal year are rather good.

A TREASURY INCOME BOND †

ROBERT HANEY SCOTT *

IT IS officially estimated that federal expenditures will exceed tax receipts by $13 billion during fiscal years 1959 and 1960.[1] Unofficial estimates run much higher due to the expectation that Congress will approve expenditures in excess of those requested by the present administration. Treasury officials are wondering from whom they will be able to borrow this tremendous sum, and accordingly, are seeking ways to make the purchase of Government securities more attractive to lenders.[2]

At first glance one might suppose that the Treasury would have no borrowing problems if it offered sufficiently attractive rates of interest. But this view ignores the fact that an "inflationary psychosis" seems to prevail among lenders and that the Treasury must operate within an interest-rate ceiling.[3] That lenders believe inflation is in prospect is evidenced by the fact that dividend rates on stock purchases are currently much lower than interest returns on fixed obligation securities. Thus, like other issuers of such securities, the Government must pay an "inflation premium" in order to assure successful sales of its maturities.[4]

A second deterrent to the sale of Treasury issues is the expectation that inflationary pressures along with Federal Reserve action will bring about higher interest rates, and hence, falling bond prices. Thus, if an investor feels he may be unable to hold a security until maturity, he will avoid the purchase of an asset expected to decline in value. This would be true even if the coupon is high enough to protect him against loss due to the declining value of the dollar.

If inflation does occur, the payment of a premium in the form of higher interest rates is warranted as a protection for the bondholder. But if it does not

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1 *Economic Report of the President,* transmitted to the Congress, January 20, 1959, p. 43.

2 On December 8, 1958 the Treasury offered a 26-week auction bill in addition to its usual 13-week offering. On March 19, 1959 the Treasury announced that it would establish a quarterly pattern of one-year auction bills. The short maturity and easy turnover of these obligations tend to make them attractive to lenders. For a discussion of these and other recent developments in the field of Treasury debt management see: "New Techniques in Debt Management," *Business Conditions,* Federal Reserve Bank of Chicago, April 1959, pp. 10-15. In addition, a technical study of the Government securities market by Treasury and Federal Reserve officials was announced early in March 1959.

3 Much of the interest-rate limitation is of a political nature. However, the maximum coupon which can be attached to a security with maturity greater than 5 years is 4¼ per cent per annum. 31 USC 752.

4 Of course, other factors enter the picture as well. For example, since corporate profits are taxed and since interest payments may be deducted from profits as an expense item, corporations have a strong incentive to issue bonds instead of stocks, all of which tends to result in higher interest returns on bonds in comparison with dividend returns on stock.

occur, the taxpayer must nevertheless carry the extra burden. Thus, there are difficult equity problems involving the treatment of creditors and taxpayers.

Several, not altogether unsuccessful, attempts have been made to solve this problem. For example, in 1952 and again in 1958 the French government issued securities which were guaranteed against changes in the domestic value of the franc in terms of gold.[5] In 1958 the Mexican government issued a security guaranteed to protect the holder against changes in the general price level.[6] Certain Scandinavian countries have issued similar securities. Use of such constant-purchasing-power bonds has been recommended by Marshall, Keynes, Slichter, Bach, Musgrave, and Goode.[7]

There is, however, another possibility which is suggested by an instrument of corporate finance, the income bond.[8] This is a bond on which interest payments are made provided the corporation has sufficient earnings. A variant of the corporate income bond might be issued by the Treasury. Instead of being related to some price index as a constant-purchasing-power bond would be, the "income" bond might be tied to the GNP, or perhaps, to tax receipts.[9]

Consider a security the maturity value of which would change along with the change in GNP that takes place during the period for which it is held. If GNP changes upward solely because of a price-level increase, then holders would be guaranteed against loss just as they would if the maturity value of the bond de-

[5] On June 13, 1958 the French government announced the issue of a tax-free, 3½ per cent bond pegged to the gold Napoleon (a 20-franc coin), to be amortized over a 54-year period. No limit was set on the amount to be subscribed although the government reserved the right to close the loan without notice. Provision was made to allow conversion of the 1952 gold-pegged issue to the new issue at a premium. These loans are practically identical and are now quoted in the Stock Exchange as a single security. They are exempt from inheritance, income, and gift taxes. Gold may be bought and sold freely within metropolitan France, but international movements of gold require special authorization from the Bank of France. On the internal free market gold usually sells at a premium which has ranged as high as 35 per cent above the official franc equivalent price of $35 per ounce. Gold coins typically sell at a higher premium than the ingot and repayments are tied to the Napoleon. But the repayment is increased proportionately only when the market price is greater than a minimum reference price. Although the official price of gold was raised by the devaluations in August 1957 and December 1958, the index feature of the loan, being related to the free market reference price, has not been operative.

[6] The bond issue was made in order to raise funds for the development of Mexican oil resources. It carries an annual rate of interest of 7.6 per cent. A wholesale index of prices in Mexico City calculated by the Bank of Mexico is used to determine the increase in the value of the bonds. The monthly average of the index for the preceding 12 months must increase by 2.5 per cent, or a multiple thereof, before any adjustment is made in the bond price. Coupon interest payments are calculated on the adjusted value of the bond, hence interest is also protected against depreciation of the peso. Principal and interest will be paid at par value even if the price index should fall below the base index. Thus, the creditor is guaranteed against loss regardless of the direction of price movements. The bonds will be amortized by means of public lotteries to be held each six months until 1968. In April 1959, the bonds were selling at 101¼ representing the first and only change in price thus far as a result of the rise in the wholesale price index.

[7] See Richard Goode, "A Constant-Purchasing-Power Savings Bond," *National Tax Journal*, Vol. IV (December, 1951) pp. 332-340, and the bibliography contained therein.

[8] It is sometimes called an "adjustment" bond. For a discussion of corporate issues of such bonds see H. G. Guthmann and H. E. Dougall, *Corporate Financial Policy*, 2nd edition (New York: Prentice-Hall, 1948) pp. 145-149 and 600-601; and B. Graham and D. L. Dodd, *Security Analysis*, 3rd edition (New York: McGraw-Hill, 1951) pp. 372-378.

[9] Since tax receipts are highly correlated with income, either variable might be used. A problem in using tax receipts would arise when changes in tax laws take place, necessitating inclusion of an appropriate adjustment provision in the terms of the bond.

pended upon changes in the price level. Thus, it would provide an effective hedge against inflation. But it would have the additional feature that would appeal to those who believe in the future growth of our economy. Investors look to the stock market for a hedge against inflation, but also because of a desire to have their asset holdings grow in value along with the economy. Hence, great interest is found in so-called "growth" stocks. An "income" bond would provide investors with a debt instrument that shares the advantages of a growth stock. Moreover, in being tied to the general development of the economy it would have much of the appeal now engendered by characteristics of mutual funds. These are attractive because of the diversification they offer the small, middle-class saver who wants a "share in the future of America." The phenomenal expansion of mutual funds in recent years is indicative of their appeal to individuals who have stopped adding Treasury savings bonds to their investment portfolio. The speculative nature of an "income" bond could be entirely eliminated by the inclusion of a redemption feature. In the event of a downturn in GNP, holders would take advantage of this feature and be just as well off as holders of cash or other fixed obligation securities. Such a bond would seem to have great potential appeal that might be exploited by a Treasury advertising campaign.

Designing the detailed provisions of an "income" bond would entail considerable effort and no attempt to do so will be made here. However, the following are some of the problems of design to be faced by Treasury officials: (1) Would only the principal or both interest and principal be related to GNP? (2) What redemption features should it contain, if any? (3) Would the instrument be marketable? (4) Would they be eligible for purchase by commercial banks?

There is no intent to underestimate the importance and difficult nature of such questions, but assuming that appropriate answers to them could be found, consider briefly some of the aggregative economic effects likely to result from the issue of a Treasury income bond.

First, if the community expected inflation and/or prosperity, purchasing power applied to these bonds would be shifted away from durable goods and stocks, all of which would tend to exert a countercyclical influence.

Secondly, if inflationary pressures exist at the time of maturity, holders would have an incentive to "roll-over" the issue.

Thirdly, those who would otherwise unload Treasury obligations in order to take advantage of the more lucrative yields available in prosperous times would tend to stabilize their portfolios.

Finally, if expectations regarding economic activity were pessimistic, it is true that holders of income bonds would want to unload or redeem them. But this would present no problem of debt management, because under these conditions the Treasury always finds a ready market for securities of the usual variety.

Conclusions

In the absence of Federal Reserve support, the Treasury periodically finds it difficult to borrow at "reasonable" costs. The Treasury's response in these periods has typically been to offer larger amounts of short-term debt. Offering

highly liquid assets to a community reluctant to purchase long-term fixed obligation bonds not only makes Treasury funding problems more difficult but also tends to contribute to inflationary pressures. The " income " bond would help solve the Treasury's dilemma, appeal to the public by providing a hedge against inflation, and have a countercyclical effect on inflationary forces. Although a bond of this sort may appear somewhat novel, imaginative techniques must be used if excessive interest charges are to be avoided, or if inflationary Federal Reserve support is to be avoided.

LIFO COST OR MARKET—SOUND ACCOUNTING PRINCIPLE OR TAX DEVICE?

J. F. BARRON *

SINCE the late 1940's businessmen have been advocating an amendment to the inventory-valuation provisions of the income-tax laws to allow the use of the lower of cost or market, for income-tax puposes, in conjunction with LIFO. It is fairly safe to assume that pressure will continue for an amendment of this nature, and it is the purpose here to examine some of the reasons set forth in behalf of such an amendment.

Cost or Market as a Corrective for Treasury-Caused Inequity

Inequitable treatment of certain taxpayers is said to exist because of an " erroneous " interpretation by the Treasury of the provisions of the Revenue Act of 1939. This statute legalized LIFO for income-tax purposes for " all " industries. The Treasury, in its application of these provisions, debarred certain taxpayers from using LIFO in computing their income tax liability.[1] In 1947 a decision by the Tax Court reversed this interpretation and allowed formerly debarred taxpayers to use LIFO.[2] The Treasury's regulations concerning the application of the provisions of the law, however, have prevented the *retroactive* election of LIFO so that certain taxpayers who would have elected LIFO in the early 1940's, except for the Treasury's attitude at the time, and who, in 1947, were declared eligible to use LIFO, now are prevented from going back to the earlier period with their election. Since, according to the Tax Court, the Treasury was incorrect in preventing these taxpayers from using LIFO, and since these taxpayers cannot now retroactively elect LIFO, an inequity is said to exist. In the absence of allowing retroactive election, the use of the lower of cost or market in conjunction with LIFO has been advocated as a (partial) corrective for this inequity.[3]

In order properly to assess this proposal it is necessary to have some idea of the magnitude of the " inequity " involved, and the nature of the correction that would result from allowing the use of the lower of cost or market with LIFO. The " inequity " arises from the fact that certain taxpayers were, in light of the 1947 Tax Court decision, wrongfully restrained from using LIFO. Thus, compared to those taxpayers whom the Treasury allowed to use LIFO, and those who continued to use it in the face of Treasury opposition and were later confirmed in their right to do so by the Tax Court, these taxpayers have suffered an

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[1] See J. F. Barron, " How the Retroactive Election of the LIFO Option Works," 36, no. 8 *Taxes* 565 (1958).

[2] *Hutzler Brothers Company,* 8 TC 14 (1947).

[3] See Herbert T. McAnly, " The Current Status of Lifo," 105, no. 5 *Journal of Accountancy* 55-62 (1958); General Revenue Revision, Hearings before the Ways and Means Committee, 83d Cong., 1st sess., statement by Maurice E. Peloubet, 620-621.

inequity.[4] Consequently, it is said, some method should be provided to correct this inequity stemming from the Treasury's incorrect interpretation of the tax laws.[5]

The " correction " supplied by allowing cost or market with LIFO apparently would work as follows:

The " wronged " taxpayers involved presently *have* the privilege of electing LIFO for tax purposes if they so choose. They do not take advantage of this privilege, it is said, because they have been paying taxes on profits arising from " written-up " inventory values (while on FIFO) and the adoption of LIFO would prohibit them from writing these inventories down in the event of a price decline. This would forestall the tax savings that would result from the writing-down. This follows because present tax provisions make the *LIFO* inventory base value that existing at the time LIFO is elected. Thus, if LIFO is now adopted in order to gain the tax savings associated with its use during periods of rising prices, the taxpayer will forego the chance of recovering some of the taxes he has in the past paid on written-up (FIFO) inventories.

[4] See Douglas H. Eldridge, " Issues Raised by Proposal to Grant Cost or Market Option with Lifo," *National Tax Journal*, Vol VI (1953) p. 52.

[5] As Maurice E. Peloubet stated: " If the principle of the Hutzler Bros. case was correct at the time it was decided, then it was correct in 1939. The error was made by the Bureau of Internal Revenue in interpreting the statute . . . . " General Revenue Revision, *op. cit.*, p. 620.

This reasoning is erroneous in itself. Principles are not absolute. They arise within an environment and the environment at the time of the Hutzler decision differed considerably from the environment in 1939. Also, of course, it does not necessarily follow that, given an inequity, some method " must " be found to correct it. It may be that the cost of the correction exceeds the value of the correction, or it is possible that the " correction " will introduce more " inequity " than it removes.

The cost-or-market option should be allowed with LIFO, it is said, because this will enable these taxpayers presently to adopt LIFO, gain whatever benefits are associated with its use when prices are rising, and also not forego the tax savings connected with reducing inventory values in the event of a price decline. Under present law taxpayers have to choose between these alternatives. If the cost-or-market option were allowed with LIFO both would be available.

These taxpayers presently have the ability to write down their inventories in the event of a price decline (by continuing on FIFO) and, thus, recoup taxes paid on written-up inventories. Any " correction " supplied by allowing cost or market with LIFO thus would appear to consist of the present value of (future) tax savings that would result from the election of LIFO (which election would be encouraged by allowing cost or market, and which supposedly would not take place in the absence of cost or market).

The magnitude of the " inequity " for which cost or market is to serve as a corrective would appear to be the present value of the (past) tax savings that would have accrued to the taxpayer for the period beginning at the time he *would* have elected LIFO had he not been debarred by the Treasury, to the time he *could* have elected LIFO. Any similarity in the amount of the inequity and the amount of its corrective would appear to be accidental.

The primary disadvantage associated with allowing cost or market as a corrective for this " inequity " is that its benefits would accrue not only to those taxpayers " wronged " by the Treasury, but also to taxpayers not wronged. It would appear to be a " shotgun " correc-

tion for a specific inequity since its benefits would accrue to all taxpayers on LIFO (in the event the price level declined below the level at which individual taxpayers elected LIFO). Windfall gains would accrue (if prices declined) to LIFO taxpayers not "wronged" by the Treasury. In addition, many taxpayers who would not have elected LIFO on its merits, and others who would not now so elect it, would be stimulated to elect it if the danger of future price declines were to be eliminated by the cost or market option.

Inequity, if it can be defined, should perhaps be corrected, but it does not seem reasonable to correct it at the cost of introducing windfall gains to those not suffering the inequity being corrected, or at the expense of introducing other inequities into the system. Since it is fairly safe to assume that the total level of government activity will not be reduced as a result of (and equal in amount to) the reduction in the tax-take that would result from the reduction in taxes paid by LIFO users, such a reduction would mean that *other* segments of the economy would bear an added burden. This would not appear to be an improvement in equity.

Cost or Market as a "Sound" Accounting Principle

The cost or market option with LIFO is sometimes advocated because it is said that not allowing it forces LIFO taxpayers to comply with an "unsound" accounting principle, that it forces such taxpayers, in periods of declining prices, to carry their inventories at "unrealistic" figures, and that it violates "generally accepted" accounting principles.[6]

Neither the tax laws nor the Treasury's regulations forbid the use of cost or market with LIFO for the guidance of management, or for "outside" reports.[7] Management is free to use any method it wishes for its decision-making. Since this is so, the "forced" violation of sound accounting principles must stem from the fact that cost or market cannot be used with LIFO for *tax* purposes. Or, stated differently, it implies that "sound," "generally accepted" accounting principles should be accepted for tax purposes. Such logic is erroneous since it ignores the (understandable) influence of economic motivation on standards of acceptability. Economic motivation being what it is, the level and type of taxes in existence will be one, if not a major, factor in determining the accounting principles that taxpayers "generally" accept.

Since the income tax is levied on stated profits, and since the present level of taxation is relatively "high," it is reasonable to suppose that any device which will reduce stated profits (without reducing actual profits) is apt to become generally accepted by taxpayers.[8] During periods of rising prices LIFO will serve to reduce stated profits as compared to FIFO. The opposite is true during price declines. In the absence of restraints taxpayers would, for tax purposes, undoubtedly change from one method to the other as it suited their purpose. Lacking complete freedom to do this, the use of the

[6] See, for example, General Revenue Revision, *op. cit.*, pp. 610, 613.

[7] Treasury Decision 5199, Internal Revenue Bulletin, Cumulative Bulletin 1942-2, pp. 83-84; Treasury Decision 6336, Internal Revenue Bulletin 1958-51, pp. 30-31.

[8] One might safely predict that, if allowed for tax purposes, a generally accepted accounting principle called "Charge to a Reserve to Reduce Income Tax Liability" would develop. Probably LIFO itself, for all but a few "basic" industries, is a "tax device."

cost or market option with LIFO will (at least partially) accomplish the same result.

In these terms no further explanation of the taxpayer's desire to use cost or market with LIFO would be necessary. Also, in these terms, there is no necessary reason why any accounting principle that happens to be "generally acceptable" should also be acceptable for tax purposes. In addition, there is no necessary reason why an accounting principle accepted for tax purposes under one set of circumstances should be acceptable for tax purposes under all circumstances. This applies to the cost or market option since, from a tax standpoint, there are important differences in the results obtained when using the method with FIFO and LIFO.

Income, in an exchange economy, is reckoned in terms of money. An enterprise begins its life with this asset. In the process of performing its functions other assets are acquired, traded, and held. If the period for which the income of the enterprise was to be determined was the life of the enterprise no great difficulty would arise in the computation of (money) income since at the end of the life of the enterprise all of its assets would again have been reduced to money. The problem, basically, would be one simply of recording money transactions. However, management decision-making, custom, and tax laws require that income be computed for periods shorter than the life of the enterprise. Since income is computed in money terms, and since some (most) of the assets of the enterprise are in non-money form, it is necessary to value these non-money assets in money terms. This can, and often does, result in differences of opinion.

Basically, varying money values placed on the non-money assets of an enterprise for the purpose of stating income for periods shorter than the life of the enterprise will not distort the statement of total income over the life of the enterprise. They will, however, affect the manner in which this total income is allocated to various accounting periods *during* the life of the enterprise. This is true if consistency rules the valuation procedure—that is, if values placed on the assets during one period are carried forward to a future period.

The inventory valuation method that is used affects the stated income of a period through its effect upon the cost-of-goods-sold section of the income statement. Whatever method is used, its purpose is to place a money value on the ending inventory of a period. This value, together with the value of the beginning inventory and the value of purchases for the period, will determine the cost of the goods that enter into sales for the period.

Since the cost of goods sold is computed by deducting the value of the ending inventory from the sum of the values of the opening inventory and purchases, the greater the value that is placed on the ending inventory the lower will be the cost of goods sold and, thus, the greater will be the stated income for the period. A reduction in the value of the ending inventory will serve to increase the value of the goods charged to sales and, thus, reduce the income stated for the period. So long as the value placed on the ending inventory of one period is carried forward to some future period no distortion will occur in the total income stated for the life of the enterprise. All that is affected is the manner in which this total income is

allocated among various accounting periods. This is true of both LIFO and FIFO. They differ only in the manner in which they allocate income among the various accounting periods.

When the assumptions of FIFO are used the value that is placed on the ending inventory of one period becomes the value of the beginning inventory for the immediately following period. Thus, a reduction in the value of the ending inventory (say to " market " where prices have declined) will result in a reduction in the income that is computed for that period. With FIFO, however, the goods on hand at the beginning of a period are charged to sales before other goods. As a result, the " low valued " opening inventory (resulting from a reduction in the value of the previous period's ending inventory) will serve to increase the income stated for this (following) period. There is, thus, only a one-period postponement of stated income (and any taxes thereon).

When the assumptions of LIFO are used, such a reduction in the value of the ending inventory of one period will not alter *total* stated income any more than when FIFO is used. If the (reduced) inventory value is carried forward to the sales of a future period it will, when it enters sales, serve to increase the income stated for that period. The decrease in the stated income of one period will be offset by an increase in the stated income of some future period.

The difference in the two methods, of course, is in the timing of the recording of the (lower and higher) stated incomes, and the payment of taxes thereon.

When FIFO is used a reduction in the value of the ending inventory causes a one-period postponement of stated income (and taxes). With LIFO, however, this postponement continues until such time as the " low valued " goods enter into sales. This occurs, under the assumptions of LIFO, when the physical inventory is (partially) liquidated. In the absence of this liquidation these " low valued " goods do not enter into sales. Under these conditions a going concern using LIFO could postpone indefinitely the increase in stated income which, with FIFO, would occur in the period immediately following the write-down to market. In turn, this could result in an indefinite postponement of the tax liability on this part of the income of the enterprise. If tax rates should decline by the time the " low valued " inventory is charged to sales (or if the stated income at that time is so low that no tax liability is incurred), the tax liability on this portion of income might be avoided completely.[9] This phenomenon could well be sufficient to explain why LIFO cost or market is " generally " acceptable to the business community, but not to the tax authorities.[10]

Unrealistic Inventory Values Without Cost or Market

Other arguments to the effect that cost or market should be allowed with

[9] If tax rates have risen, or a higher bracket has been reached, at the time of liquidation an increased tax liability could, of course, result.

[10] Past proposals for amending the tax laws to allow LIFO cost or market have provided for a write-up in the LIFO inventory value in the event that market price rises following a write-down. Raymond A. Hoffman, " Tax Shortcomings in the LIFO Provision," 31 *Taxes* 407-408 (1953).

Such proposals have been resisted on the basis that they violate accepted accounting principles. As Wallace M. Jensen stated, " Any requirement that a writedown of LIFO inventory to market be restored to income if prices increased in a subsequent year may result in a departure from generally accepted accounting principles." General Revenue Revision, *op. cit.*, p. 611.

One gets the impression that accounting principles become " generally " accepted insofar as they serve the interest of the person accepting them.

LIFO because otherwise sound (realistic) accounting principles are violated during periods of declining prices appear to be something less than logically consistent.[11]

Proponents of LIFO have, generally, stated that LIFO's function is properly to state income by charging goods to sales at current prices—matching costs and sales at (basically) the same price level.

Underlying this approach is the view that a going concern must maintain some normal, basic physical inventory at all times, and that this " base stock " is not actually for sale. To continue as a going concern an enterprise must provide for the replacement of inventories out of income. It should not regard as available for other purposes that portion of its stated income arising from the sale, at " high " prices, of goods purchased at " low " prices. In order to stay in business it must purchase replacements at the current price level.

LIFO's function, thus, is to state income correctly by matching current cost prices with current sales prices. It performs this function by valuing the inventory at a fixed price level so that, so long as the physical inventory remains unchanged, the purchases of a period will be charged to the sales of that period. In this process the stated value of the inventory bears no necessary relation to its liquidation (market) value. The inventory is not for sale, is not related to current values, and is an " amorphous residual." [12]

If LIFO's function *is* properly to state income and *not* to serve as a " tax device," there is no reason for the use of cost or market with it. As a matter of fact, if LIFO correctly states income by matching current costs with current revenues the use of the cost or market option with it will *mis*state income. A write-down to market, for example, during a period in which prices decline below LIFO cost will result in charging to sales of that period not only goods sold at current cost levels, but also will result in a charge representing an inventory loss. Income stated for the period will not reflect the results of operations but will, in addition, be burdened with a non-operating (non-realized) " loss." [13]

If a LIFO inventory is " not for sale " there is no justification for charging to income the difference between the LIFO value and the (lower) market value involved. Even on the basis that losses should be accounted for when realized there would appear to be no necessary reason for such a charge. A decline in the market price of something that is not for sale hardly gives rise to a loss. If the loss is to be realized it will be realized when the inventory enters into sales. Until this " loss " is realized by liquida-

[11] Such arguments are, of course, consistent from the standpoint that the results, if achieved, will serve the personal interest of those achieving them. If the *actual* purpose of an accounting device is (partially) to reduce tax payments, then anything that will result in such a reduction is logically consistent. This is not, however, the generally *stated* purpose of such devices.

[12] There are available many statements of the mechanics and rationale of LIFO. Among others see Maurice E. Peloubet, " Last-in, First-out Once More," 69 *Journal of Accountancy* 446 (1940); Ibid., " Has Lifo Fallen? " 85 *Journal of Accountancy* 298 (1948); *Ibid.*, " Choice of Inventory Valuation Method Depends on Specific Needs of Each Business," 91 *Journal of Accountancy* 70 (1951); K. Lacey, " How the Last-in, First-out Principle Encourages Economic Stability," 87 *Journal of Accountancy* 200 (1949); George O. May, " Inventory Pricing and Contingent Reserves; Comment on New Accounting Research Bulletin," 84 *Journal of Accountancy* 361 (1947).

[13] See John V. Van Pelt III, " Reasons Why the Accounting Profession Should Encourage a Broader Utilization of Lifo," 96 *Journal of Accountancy* 455 (1953).

tion a " true " reflection of income, by LIFO's own standards, requires only the continued application of current costs to sales. In achieving this result the *level* of prices at which the LIFO inventory is carried, so long as it remains constant, has no effect upon the performance of LIFO in charging current costs to sales.[14]

During the period in which taxpayers were attempting to get LIFO legalized for tax purposes its opponents criticized the method on the grounds that during periods of rising prices its use resulted in an unrealistic inventory value. Proponents, however, argued that this was unimportant, that the primary concern was for a " correct " statement of income.[15] LIFO's advocates appeared to show little concern for its " distortion " of the balance sheet. If it were desired to bring the inventory valuation to the attention of users of the balance sheet they believed that an explanatory note to this effect would suffice.

There appears to be no particularly compelling reason why, during periods of declining prices, the same procedure would not be satisfactory. Except where collapse of the enterprise is imminent, the market value of a LIFO inventory appears to be relatively unimportant and could, certainly, be taken into account by means of notes to the balance sheet. Since it is a balance sheet problem it appears to be soluble by means other than charging a loss, which may never be realized, to the income of an accounting period.

[14] See, for example, K. Lacey, *op. cit.*

[15] See footnote 12 above.

Conclusions

Most of the arguments advanced in favor of allowing the cost or market option to be used, for tax purposes, with LIFO appear primarily to represent pleadings in self interest.

As a corrective for any inequities that may exist in the present distribution of the tax burden, the cost or market option appears to be a rather unsatisfactory device. In addition, there is no necessary reason why it should be allowed with LIFO on the basis that not allowing it violates " sound " and " accepted " accounting principles. Both " soundness " and " acceptability " are relative concepts and will be influenced by the environment within which the acceptor operates. Since tax factors are an important element in the business environment it is safe to predict that tax considerations will affect " soundness " and " acceptability." Devices that today are " unsound " and " unacceptable " may be so (partially) because the gain associated with their use is not sufficient to make them " acceptable."

SOURCES OF FARM INCOME UNDERREPORTING: GROSS RECEIPTS OR DEDUCTIONS?

WAYLAND D. GARDNER *

RECENT *National Tax Journal* articles have whetted interest in income tax administration and compliance.[1] These studies illustrate the difficulty of unraveling compliance by income source and offer a variety of conclusions as to the extent and explanation of non-compliance among income sources. For farm income, in particular, estimates of the extent of non-compliance differ markedly and a variety of explanations are offered.

Pioneering postwar studies of income tax reporting by income source indicate that roughly 35 to 40 per cent of net farm entrepreneural income appeared on federal income tax returns in the early post World War II years.[2] The Groves study of Wisconsin state income tax returns for 1954 and 1955 (in which the author participated) yielded a finding that the farm operators studied reported some 65 to 70 per cent of their reportable net farm income and that the tax reported on this income was not more than 65 to 70 per cent of that which would have been payable had net farm income been fully reported. Stocker and Ellickson, in their recent article, contend that farm income tax compliance is still higher, although no specific estimate of net farm income compliance is offered.

Undoubtedly, some of the diversity among these quantitative findings on farm income tax compliance arises from differences in data sources, in the income concept used, and in the selection of farm incomes used for the studies. Certainly, these findings must be accepted as indicative that further effort in the area is needed. It is important, therefore, to note certain areas in which a consensus appears to be developing and to recognize those aspects of farm income tax compliance which may be unique and which have an important bearing upon the administration of taxes on farm income.

Perhaps the most comforting area of substantial agreement lies in the view that farm income tax compliance, although rather poor in the not-too-distant past, is undergoing a steady improvement which has placed, or can be expected eventually to place, farm income on a par with other entrepreneural income. A large part of the responsibility for both the low compliance and for the apparent improvement is attributed to the quality of the farm records which constitute the basis for the farmer's report of his income. Similarly, the farmer's familiarity with the income tax return and his obligation thereon appears to be improving, after

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[1] Harold M. Groves, "Empirical Studies of Income Tax Compliance," *National Tax Journal*, XI (December 1958), pp. 291-301; Frederick D. Stocker and John C. Ellickson, "How Fully Do Farmers Report Their Incomes?", *National Tax Journal*, XII (June 1959), pp. 116-126.

[2] Selma F. Goldsmith, "Appraisal of Basic Data Available for Constructing Income Size Distributions," *Conference on Research in Income and Wealth* (New York: National Bureau of Economic Research, 1951), Vol. 13, pp. 267-377; Daniel M. Holland and C. Harry Kahn, "Comparison of Personal and Taxable Income," Joint Committee on the Economic Report, 84th Congress, 1st Session, *Federal Tax Policy for Economic Growth and Stability*, 1955, pp. 313-338.

a rather abrupt introduction, and is credited with some role in raising compliance. Considerable credit appears to be due to educational institutions and to the educational endeavors of the Internal Revenue Service in extending the frontiers of farm accounting and particularly of farm income tax accounting.

Changes in the economy itself also have stimulated the development of better farm income tax compliance. As farming has become more specialized and as farms have grown larger, detailed accounting has become more and more essential to profitable farm operations. The more firmly established marketing channels of specialized farming appear to have eased the accounting task (at least in tabulating gross receipts) and the enlarged demand for information by governmental farm agencies has helped the farmer recognize the importance of his paper work.

In a rather negative sense, a consensus may be developing even in the troublesome area of farm expense deductions. At least, expert opinion generally recognizes the very imperfect state of knowledge of the farmer's compliance in claiming allowable farm deductions. Farm deductions, it is argued, may be overclaimed, or they may be underclaimed, or it may be that the net result of individual variations could yield, in the aggregate, at least, a listing of farm deductions approximating actual experience.

In part, the view that farm deductions are overclaimed recognizes the possibility that personal expenses on the farm can easily become confused with the deductible expenses of farm operation. To a greater extent, perhaps, the allegation of overclaimed deductions constitutes an extension to farmers of the more general suspicion (and evidence) that padded deductions offer a convenient and direct means of minimizing taxes. This suspicion, in turn, may relate to the belief that excessive deductions are more difficult to detect in the auditing process than are underreported gross receipts, especially where these receipts are from relatively few sources and may be covered by source information or withholding.

The view that deductions may be underclaimed, on the other hand, generally is based upon the previously noted inadequacy of farm records. Incomplete records, it is contended, are more likely to produce errors of omission than of commission; the farmer may fail to claim his full deductions, even after his conscience has been burdened by the insertion of a little padding. Furthermore, if farm records are, in general, imperfect, one might easily conclude that deductions, composed of many small cash expenses, suffer more from omissions than do gross receipts totals, which are likely to include relatively fewer categories and larger transactions coming less frequently and probably by check. Thus, the honest taxpayer, attempting to complete his return on the basis of incomplete farm accounts may well overlook more allowable deductions than reportable gross receipts. It would appear, in fact, that in research dealing with aggregations of many taxpayers, the results of padded deductions on the part of some taxpayers very possibly would be overbalanced by errors of omission arising from the inadequacy of farm records.

Because of the very formidable difficulties involved in a study of compliance in claiming farm deductions, many studies are forced to reach conclusions relating to net farm income compliance largely on the basis of find-

ings dealing with the reporting of gross farm receipts. That the hazards involved in making this long leap from gross receipts to net income are very great can hardly be denied. Yet, certain of these hazards do, upon occasion, appear to go unrecognized. Certainly, the necessity of reaching some conclusion concerning the claiming of deductions raises the danger that this area of compliance may be miscalculated. The hazards, however, go beyond this, particularly in the study of farm income. Specifically, the rather high ratio of deductions to gross receipts associated more and more with farming, produce a very potent " leverage effect " which can make an apparently moderate omission of gross receipts bulk very large indeed in terms of net farm income. For example, allowable farm deductions, on the average, appear to amount to some two-thirds, or even as much as three-fourths, of reportable gross farm receipts. Thus, assuming for the moment that the deductions are correctly reported, an omission of as little as 10 per cent of *gross* farm receipts can amount to a failure to report 30 per cent, or as much as 40 per cent, of *net* farm income, depending on the ratio of deductions to gross receipts. Of course, the results in terms of net farm income would be less drastic if deductions had been underclaimed and more drastic if they had been overclaimed. It seems inappropriate to conclude, therefore, that a 10 per cent, or even a smaller, underreporting of *gross* farm receipts implies a not-too-unacceptable level of compliance for *net* farm income; or that the failure to report all gross farm receipts may not be the major obstacle to the improvement of farm income tax compliance.

For purposes of farm income tax administration, the conclusion to be drawn from the recognition of the " leverage effect " of proportionally large allowable deductions in relation to gross receipts would, in fact, appear to be the reverse of the above viewpoint. Farm deductions may be overclaimed, or they may be underclaimed, and, in either case, of course, steps should be taken to detect the actual situation and to encourage proper reporting. Yet, the view is widespread that gross receipts are, in the aggregate, underreported. Corrective measures, therefore, are clearly in order in this area and will have, through the " leverage effect," a sizable impact on the level of net farm income tax compliance.

Dollar for dollar, of course, errors in reporting are equally important in terms of the amount of net income and tax liability, whether they appear among gross receipts or among deductions. Thus, equity among individual taxpayers requires continuing diligence in the auditing of both gross receipts and deductions on individual returns and in the encouragement of complete voluntary reporting. In the search for equity among income groups and various income sources, however, attention must be directed to the relationship between receipts and deductions as well as to these categories individually.

The Officers, Vice-President PAUL E. ALYEA, Secretary LEO MATTERSDORF, and Treasurer LEE P. MILLER, and the Executive Committee members,

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join with me in sending you best wishes for

A Merry Christmas and Happy New Year

WALTER W. WALSH
President

From the Executive Director

President Walsh, the officers and members of the Executive Committee have extended best wishes for the Holidays—I heartily join in their greetings!

With the tremendous impetus given the National Tax Association by the success of the Houston Conference, I feel sure a great year is in store for our association.

Houston Conference

I would be remiss if I were not to tell the membership of the many letters of congratulation, as well as verbal expressions, reaching me, directly and indirectly, to the effect that the 1959 Conference was outstanding in every respect.

For this notable success, we are grateful for two selections by Past President Bowers, who, with their committees, went far beyond any expectations. The Program, the meat of any conference, was noteworthy both in detail and in diversification. No criticisms were heard . . . yet, there were innumerable voluntary and enthusiastic words of praise. Alvin A. Burger, the Program Chairman, deserves the gratitude and commendation which was given him by the Executive Committee and the membership. His work and magnificent results will long be remembered.

Likewise, Philip S. Robira (also commended by the Executive Committee and membership) and his most capable committee left no stone unturned to produce one of the best entertainment programs ever scheduled and carried out at any annual conference. Those who missed the barbecue and rodeo, and then the banquet, characterized by good taste and excellence, were unfortunate indeed.

The real point is that not many missed anything! Registration was just about at an all-time high, with more than a thousand registered. As usual, some attended and did not register. This is a problem to be worked out in the future.

Mrs. Robira arranged an unusually fine program for the ladies. Their participation in all such conference functions as the banquet and luncheons gave us a pattern to be followed. All events were well attended.

My own enthusiasm makes it difficult for me to write *FINIS* to my conference comments. Finally, I must say that Past President Bowers and Secretary Mattersdorf contributed far beyond the duties of their official positions. I recommend the reading of the President's address in the *Proceedings*. It epitomizes the experiences and views of an outstanding State tax administrator whose leadership has meant so much to the National Tax Association.

New York Conference

Because the 1960 Conference will be much earlier than this year, each member should immediately note the time and place, and start his preparations to attend. JOT DOWN NOW:

53rd ANNUAL CONFERENCE ON TAXATION
STATLER HILTON HOTEL
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This means the opening reception will come late on Labor Day (Monday) afternoon. It was thought the professors, whose many contributions we value so highly, would be better able to attend at the earlier date. The weather, if, by chance, warm, will not be noticed, as all meeting and guest rooms in the Statler Hilton are air conditioned. So plan right now to be in New York in September, 1960.

President Walsh, a former State tax administrator, a prominent attorney and long active in National Tax Association, is considering the selection of chairmen for the Program and Local Arrangements Committees. New York, which has a large concentration of N.T.A. members, will do its best . . . and that means a superior job.

Membership

Membership in National Tax Association will be on the upswing following the Houston Conference. No member should hesitate to solicit new members or the revival of any memberships which have lapsed.

JUST USE THE ATTACHED CARD.

Walter J. Kress
Executive Director

NATIONAL TAX ASSOCIATION

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OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: memberships for students in recognized institutions of higher learning, $10; memberships for government agencies, schools, and persons receiving more than one-half of their income from employment by such agencies or schools, $10; memberships for other individuals and unincorporated entities, $25; corporate memberships, $100; persons wishing to contribute more liberally to the support of the Association, $100 to $1000.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is $5.00 per year, single numbers, $1.50. The prices of the PROCEEDINGS vary; that of the 1958 volume is $12.00.

Applications for membership, orders for publications, and general inquiries should be addressed to Walter J. Kress, Executive Director, National Tax Association, 905 Payne-Shoemaker Building, Harrisburg, Pennsylvania.
